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Litigation and Settlement of SEC Administrative Enforcement Proceedings

Arthur F. Mathews

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LITIGATION AND SETTLEMENT OF SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

*Arthur F. Mathews**

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An earlier, much abridged version of this article, without footnote citations, appeared in the litigation journal published by the American Bar Association's Section of Litigation. See Mathews, *Litigating and Settling SEC Administrative Disciplinary Proceedings*, 5 LITIGATION 30 (No. 3, Spring 1979).

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I. INTRODUCTION: THE LIKELIHOOD OF INCREASED USE OF SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

When a private Securities and Exchange Commission (SEC) enforcement investigation¹ uncovers evidence suggesting possible statutory viola-

1. 17 C.F.R. §§ 203.1 to .8 (1979). See Ferrara, *SEC Division of Trading and Markets: Detection, Investigation and Enforcement of Selected Practices That Impair Investor Confidence in the Capital Markets*, 16 HOW. L.J. 950 (1971); Lowenfels, *Securities and Exchange Commission Investigations: The Need for Reform*, 45 ST. JOHN'S L. REV. 575 (1971); Mathews, *Effective Defense of SEC Investigations: Laying the Foundation for Successful Disposition of Subsequent Civil, Administrative, and Criminal Proceedings*, 24 EMORY L.J. 567 (1975); Mathews, *Witnesses in SEC Investigations: A Primer for Witnesses and Their Counsel on the Scope of the SEC's Investigatory Powers*, 3 REV. SEC. REG. 923-32 (1970); Merrifield, *SEC Investigations*, 32 BUS. LAW. 1583 (1977); Winter, *Representing Witnesses in SEC Formal Investigations*, 5 LITIGATION 24 (Nov. 3, 1979); Comment, *The Administrative Procedure Act and the Rights of Witnesses in Investigatory Proceedings Before the Securities and Exchange Commission*, 20 AM. U.L. REV. 115 (1970). See generally 3 L. LOSS, SECURITIES

tions that, in the view of the SEC's Enforcement Staff, may warrant the imposition of disciplinary sanctions, three principal adjudicatory enforcement weapons can be initiated by the SEC and its staff: criminal prosecution;² civil injunctive actions;³ or administrative disciplinary proceedings.⁴ This article will synopsize current trends, primarily adjective law issues, in the litigation and settlement of SEC administrative disciplinary proceedings.⁵

Admittedly, the administrative enforcement proceeding has not recently

REGULATION 1945-74 (2d ed. 1961); 6 L. LOSS, *SECURITIES REGULATION* 4079-108 (2d ed. Supp. 1969). See also Markham, *Investigations Under the Commodity Exchange Act*, 31 AD. L. REV. 285 (1979); Smaltz, *Tactical Considerations for Effective Representation During a Government Investigation*, 16 AM. CRIM. L. REV. 383 (1979).

2. 17 C.F.R. § 202.5(b) (1979). See A.F. MATHEWS, *SEC ENFORCEMENT AND WHITE COLLAR CRIMES* (1979); Mathews & Sullivan, *Criminal Liability for Violations of the Federal Securities Laws: The National Commission's Proposed Federal Criminal Code, S. 1, and S. 1400*, 11 AM. CRIM. L. REV. 883 (1973); Mathews, *Criminal Prosecutions Under the Investment Company Act of 1940 and the Investment Advisers Act*, 13 B.C. INDUS. & COM. L. REV. 1257 (1972); Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901 (1971); Note, *The Securities and Exchange Commission: An Introduction to the Enforcement of the Criminal Provisions of the Federal Securities Laws*, 17 AM. CRIM. L. REV. 121 (1979). See generally 3 LOSS, *supra* note 1, at 1984-2004; 6 LOSS, *supra* note 1, at 4123-50.

3. 17 C.F.R. § 202.5(b) (1979). See A.F. MATHEWS, *NEGOTIATING SEC CONSENT DECREES: TARGETS & TACTICS FOR SETTLING CIVIL INJUNCTIVE ACTIONS* (1979); Harkleroad, *Requirements for Injunctive Actions Under the Federal Securities Laws*, 2 J. CORP. L. 481 (1977); Jaeger & Yadley, *Equitable Uncertainties in SEC Injunctive Actions*, 24 EMORY L.J. 639 (1975); Mathews, *SEC Civil Injunctive Actions — I and II*, 5 REV. SEC. REG. 969 (1972); Pitt & Markham, *SEC Injunctive Actions*, 6 REV. SEC. REG. 955 (1973); Committee on Federal Regulation of Securities, *SEC Civil Injunctive Actions*, 30 BUS. LAW. 1303 (1976); Note, *Injunctive Relief in SEC Civil Actions: The Scope of Judicial Discretion*, 10 COLUM. J.L. SOC. PROB. 328 (1974). See generally 3 LOSS, *supra* note 1, at 1975-83; 6 LOSS, *supra* note 1, at 4108-23; Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976).

4. 17 C.F.R. §§ 201 to 201.27 (1979) (SEC Rules of Practice). See Block & Barton, *Administrative Proceedings to Enforce the Foreign Corrupt Practices Act*, 7 SEC. REG. L.J. 40 (1979); Burton, *SEC Enforcement and Professional Accountants: Philosophy, Objectives and Approach*, 28 VAND. L. REV. 19 (1975); Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROB. 691 (1964); Downing & Miller, *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME LAW. 774 (1979); Tew & Freedman, *Practice in Securities and Exchange Commission Investigatory and Quasi-Judicial Proceedings*, 27 U. MIAMI L. REV. 1 (1972); Thomforde, *Controlling Administrative Sanctions*, 74 MICH. L. REV. 709 (1976); Timbers & Garfinkel, *Examination of the Commission's Adjudicatory Process: Some Suggestions*, 45 VA. L. REV. 817 (1959). See generally 3 LOSS, *supra* note 1, at 1891-944; 6 LOSS, *supra* note 1, at 4020-78.

5. For an excellent primer on litigating administrative proceedings generally, see Judge E. Barrett Prettyman's classic work published almost 20 years ago. Prettyman, *How to Try a Dispute Under Adjudication by an Administrative Agency*, 45 VA. L. REV. 179 (1959), reprinted as A MANUAL ON TRIAL TECHNIQUE IN ADMINISTRATIVE PROCEEDINGS (1961).

been the most widely used weapon in the SEC's enforcement arsenal. During the 1960's and 1970's, the SEC primarily relied upon the civil injunctive action. For example, the *Texas Gulf Sulphur* civil injunctive litigation⁶ — embracing strict duties proscribing the misuse of material "inside" information by corporate insiders, tipplers, and tippees, and novel forms of ancillary relief — sent shock waves through the corporate business community. More recently, the *National Student Marketing* civil injunctive litigation⁷ — raising sensitive questions of possible "whistle-blowing" duties of corporate and securities lawyers — has caused a somewhat nervous Bar to reassess the efficacy of certain longstanding patterns of corporate and securities legal practice. Both *Texas Gulf*⁸ and *National Student Marketing*⁹ have generated a well-stocked stream of legal literature concerning the SEC's efforts to raise the professional standards applicable to both corporate managers and their legal advisers. Not enough has been written, however, about tactics, procedures, and emerging legal principles arising from the SEC's concomitant use of administrative disciplinary proceedings to espouse fiduciary and professional standards applicable to corporate managers, corporate legal advisers, and other securities industry participants.¹⁰

6. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *rev'g* 258 F. Supp. 262 (S.D.N.Y. 1966). See also SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (S.D.N.Y. 1970), *judgment aff'd and order rev'd*, 446 F.2d 1301 (2d Cir.), *order amended*, 331 F. Supp. 671 (S.D.N.Y. 1971).

7. See, e.g., SEC v. National Student Marketing Corp., 457 F. Supp. 682 (D.D.C. 1978), *appeal docketed*, No. 79-1051 (D.C. Cir. Jan. 18, 1979).

8. See, e.g., Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271 (1965); Mann, *Prevention of Improper Securities Transactions by Employees: The Responsibility For and Feasibility of Adopting Preventative Programs*, 25 HASTINGS L.J. 355 (1974); Sandler & Conwill, *Texas Gulf Sulphur: Reform in the Securities Marketplace*, 30 OHIO ST. L.J. 225 (1969); Schuyler, *From Sulphur to Surcharge? — Corporate Trustee Exposure Under SEC Rule 10b-5*, 67 NW. U.L. REV. 42 (1972); Note, *Texas Gulf Sulphur and the Duty of Disclosure, Another View*, 55 GEO. L.J. 664 (1967).

9. See, e.g., Cheek, *Professional Responsibility and Self-Regulation of the Securities Lawyer*, 32 WASH. & LEE L. REV. 597 (1975); Hoffman, *On Learning of a Corporate Client's Crime or Fraud — The Lawyer's Dilemma*, 33 BUS. LAW. 1389 (1978); Karmel, *Attorney's Securities Laws Liabilities*, 27 BUS. LAW. 1153 (1972); Koch, *Attorneys' Liability: The Securities Bar and the Impact of National Student Marketing*, 14 WM. & MARY L. REV. 883 (1973); Lipman, *The SEC's Reluctant Police Force: A New Role for Lawyers*, 49 N.Y.U.L. REV. 437 (1974); Myers, *The Attorney-Client Relationship and the Code of Professional Responsibility: Suggested Attorney Liability for Breach of Duty to Disclose Fraud to the Securities and Exchange Commission*, 44 FORDHAM L. REV. 1113 (1976); Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?*, 61 CALIF. L. REV. 1189 (1973).

10. The pertinent literature includes: Cohen & Rabin, *supra* note 4; Johnson, *The Expanding Responsibilities of Attorneys in Practice Before the SEC: Disciplinary Proceedings*

Historically, the SEC has established professional standards for broker-dealers and investment advisers through ad hoc adjudication of administrative disciplinary proceedings.¹¹ Moreover, both prior to¹² and after *Texas Gulf*,¹³ the Commission has employed administrative proceedings as a vehicle to impose upon the corporate business community required standards of conduct to prevent the misuse of material "inside" information. Indeed, there is presently *sub judice* before the Commission an administrative disciplinary proceeding against Raymond Dirks and certain institutions, growing out of the Equity Funding fiasco. It is anticipated that the SEC will espouse further standards in *Raymond Dirks* concerning the selective dissemination by tippers and tippees of material "inside" or "market" information respecting corporate issuers.¹⁴

Similarly, in the wake of the *National Student Marketing* civil injunctive proceeding — the most important aspect of which is presently on appeal in the United States Court of Appeals for the District of Columbia Circuit¹⁵ — and the related criminal prosecution,¹⁶ the SEC apparently has intensified its pace of adjudicating administrative disciplinary proceedings con-

Under Rule 2(e) of the Commission's Rules of Practice, 25 MERCER L. REV. 637 (1974); Levine, Ferrara & Moylan, *Administrative Proceedings Under the Securities Exchange Act of 1934*, 25 MERCER L. REV. 671 (1974); Mathews, *Litigating and Settling SEC Administrative Disciplinary Proceedings*, 5 LITIGATION 30 (Nov. 3, 1979); Miller, *The Distortion and Misuse of Rule 2(e)*, 7 SEC. REG. L.J. 54 (1979); Thomforde, *Negotiating Administrative Settlements in SEC Broker-Dealer Disciplinary Proceedings*, 52 N.Y.U.L. REV. 237 (1977).

11. See generally Cohen & Rabin, *supra* note 4, at 702-08.

12. See, e.g., Cady, Roberts & Co., 40 S.E.C. 907 (1961).

13. See, e.g., Faberge, Inc., SEC 1934 Act Release No. 10,174 (May 25, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,378; Investors Mgt. Co., 44 S.E.C. 633 (1971); George Wunch, 44 S.E.C. 95 (1969); Blyth & Co., Inc., 43 S.E.C. 1037 (1969); Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968).

14. Boston Co. Inst. Investors, Inc., SEC Ad. Pro. File No. 3-5068 (Sept. 1, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,705 (initial decision of SEC ALJ), *appeal pending before the SEC sub nom.* Raymond Dirks, SEC Ad. Pro. File No. 3-5068 (1979).

With respect to misuse of undisclosed, material market information, see *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *cert. granted*, 99 S. Ct. 2158 (1979); *Oppenheimer & Co.*, SEC 1934 Act Release No. 12,319 (Apr. 2, 1976), [1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,551. See generally Fleischer, Mundheim & Murphy, *Disclosure of Investment Advice*, 6 REV. SEC. REG. 867 (1973); Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973); Koeltl & Longstreth, *Market Information Revisited*, 11 REV. SEC. REG. 843 (1978); Peskind, *Regulation of the Financial Press: A New Dimension to Section 10(b) and Rule 10b-5*, 14 ST. LOUIS U.L. REV. 80 (1969). See also *Oppenheimer & Co. (Hechler)*, SEC 1934 Act Release No. 15,994 (July 5, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,125.

15. *SEC v. National Student Mktng Corp.*, 457 F. Supp. 682 (D.D.C. 1978), *appeal docketed*, No. 79-1051 (D.C. Cir. Jan. 18, 1979).

16. See *United States v. Natelli*, 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976).

cerning the standards of care applicable to accountants and attorneys practicing before the Commission. For example, the Commission has recently litigated a public administrative disciplinary proceeding against Touche Ross & Co.,¹⁷ one of the "Big Eight" national accounting firms. It has also recently issued an administrative disciplinary opinion against a Cincinnati law firm, Keating, Muething & Klekamp,¹⁸ finding that the law firm breached applicable professional standards in connection with the preparation of various SEC filings on behalf of the American Financial Corporation. Additionally, the Commission is presently adjudicating an important administrative disciplinary proceeding against William R. Carter and Charles J. Johnson, Jr.,¹⁹ two partners of a prominent New York law firm, Brown, Wood, Ivey, Mitchell & Petty. The *Carter-Johnson* case may ultimately have a more profound effect upon the legal practice of corporate and securities lawyers than the *National Student Marketing* litigation.²⁰ Undoubtedly, the *Keating, Muething & Klekamp* case will also cause securities lawyers to reassess their professional conduct. In light of these and other recent administrative cases, an analysis of emerging considerations and issues arising in the litigation of SEC administrative enforcement actions appears to be timely.

II. PRINCIPAL TYPES OF SEC ADMINISTRATIVE PROCEEDINGS

The federal securities statutes²¹ authorize the SEC to adjudicate a myriad of administrative proceedings. Not all of them, however, are "discipli-

17. See Touche Ross & Co., SEC Accounting Series Release No. 153 (Feb. 25, 1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,175. See also SEC v. Touche Ross & Co., 438 F. Supp. 259 (S.D.N.Y. 1977), *aff'd*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,854 (2d Cir. May 10, 1979).

18. Keating, Muething & Klekamp, SEC 1934 Act Release No. 15,982 (July 2, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124.

19. William R. Carter, SEC Ad. Pro. File No. 3-5464 (March 7, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175 (initial decision of SEC ALJ), *review granted*, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

20. See, e.g., Bialkin, *Securities Law: Commission's Latest 2(e) Proceeding Profoundly Disquiets Securities Bar*, Nat'l L.J., April 30, 1979, at 25, col. 1; Klein, *Brown-Wood Decision Deserves Closer Look*, Legal Times of Wash., May 7, 1979, at 32, col. 1.

21. The federal securities statutes encompass: (i) the Securities Act of 1933 (1933 Act), 15 U.S.C. §§ 77a-77aa (1976); (ii) the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. §§ 78a-78kk (1976), *as amended by* the Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd-1, 78dd-2, 78m, 78ff (Supp. 1977) *and* the Domestic and Foreign Investment Improved Disclosure Act, 15 U.S.C. §§ 78m, 78o (Supp. 1977); (iii) the Public Utility Holding Company Act of 1935 (1935 Act), 15 U.S.C. §§ 79-79z-6 (1976); (iv) the Trust Indenture Act of 1939 (1939 Act), 15 U.S.C. §§ 77aaa-77bbb (1976); (v) the Investment Company Act of 1940 (1940 Act), 15 U.S.C. §§ 80a-1 to 80a-27 (1976); (vi) the Investment Advisers Act of 1940 (Advisers Act), 15 U.S.C. §§ 80b-1 to 80b-21 (1976); (vii) the Securities Investor Protection Act of 1970 (SIPC Act), 15 U.S.C. §§ 78aaa-78lll (1976).

nary" in nature.²² Following is a sketch of the principal types of administrative proceedings litigated most frequently under the four primary statutes — the 1933, 1934, Advisers, and 1940 Acts.

A. The 1933 Act

Pursuant to sections 8(d) and (e) of the 1933 Act,²³ the Commission adjudicates "stop-order" proceedings involving defective registration statements covering public distributions of securities.²⁴ By statute, these proceedings must be public and have only a single respondent — the issuer of the particular securities offering. In essence, the stop-order proceeding is an enforcement action against a piece of paper — the defective registra-

22. The Commission's adjudicatory functions fall roughly into the following three categories:

The first has been characterized as analogous to a "licensing" function, embracing activities such as registrations of securities under the Securities Act of 1933, registrations of broker-dealers under the Securities Exchange Act of 1934, and registrations of investment companies under the Investment Company Act of 1940. The Commission exercises its licensing power in a negative manner: by taking no action if the application is in order. In effect the Commission thus "approves" the application filed and permits it to become effective.

The second category embraces the so-called "declaration of status" orders by the Commission, including the granting or denying of exemptive orders, principally important under the Public Utility Holding Company Act of 1935 and the Investment Company Act.

The third category consists of the disciplinary functions performed by the Commission under the various statutes. Here the Commission deals with such matters as the revocation or suspension of broker-dealer registrations under the Securities Exchange Act, the issuance of stop-orders and Regulation A suspension orders under the Securities Act, and the revocation of investment adviser registrations under the Investment Advisers Act of 1940.

Timbers & Garfinkel, *supra* note 4, at 817-18 (footnotes omitted). For an early discussion of the SEC's adjudicatory functions, see ATTORNEY-GENERAL'S COMMITTEE ON ADMINISTRATIVE PROCEDURE IN GOVERNMENT AGENCIES, MONOGRAPH ON THE SECURITIES AND EXCHANGE COMMISSION, S. DOC. NO. 10, pt. 13, 77th Cong., 1st Sess. 14-97 (1941). *See also* SEC's Response to Dawson Committee 1934, *printed in* HOUSE COMM. ON GOVERNMENT OPERATIONS, 85TH CONG., 1ST SESS., SURVEY AND STUDY OF ADMINISTRATIVE ORGANIZATION, PROCEDURE, AND PRACTICE IN THE FEDERAL AGENCIES 1903 (Comm. Print 1957); Lane & Blair-Smith, *The SEC and the Expeditious Settlement of Disputes*, 34 ILL. L. REV. 699 (1940).

23. 15 U.S.C. § 77h(d), (e) (1976).

24. *See, e.g.*, Levitz Furniture Corp., SEC 1933 Act Release No. 5266 (June 27, 1976); Franchard Corp., 42 S.E.C. 163 (1964); Atlantic Research Corp., 41 S.E.C. 733 (1963); Miami Window Corp., 41 S.E.C. 68 (1962); Ultrasonic Corp., 37 S.E.C. 497 (1957). *See generally* Levinson, *Administrative Procedures in Connection with Investigations and Hearings Under the Securities Act of 1933*, in SECURITIES LAWS & REGULATIONS INSTITUTE 109 (H. Sowards ed. 1967). *See also* Stardust, Inc. v. SEC, 225 F.2d 255 (9th Cir. 1955); Las Vegas Hawaiian Dev. Co. v. SEC, 466 F. Supp. 928 (D. Hawaii 1979).

tion statement. It is intended to block the illegal public distribution of a particular issue of securities, not to discipline individuals or entities.

Regulation A suspension proceedings²⁵ are litigated under rule 261 of the 1933 Act.²⁶ In effect, these suspension proceedings are used to block an allegedly exempt public offering of securities that is being attempted through the use of a defective Regulation A offering circular; just as traditional stop-order proceedings are used to block fully registered public offerings when the filed registration statement is defective.²⁷

B. The 1934 Act

Broker-dealer disciplinary proceedings are litigated pursuant to sections 15(b)(4) and (6),²⁸ as well as sections 15A and 19(h) of the 1934 Act.²⁹ Respondents include not only the entities or persons registered (or attempting to register) as broker-dealers with the SEC but also any persons "associated" (or attempting to become associated) with a broker-dealer. The statute gives the SEC discretion to litigate such disciplinary proceedings either publicly or privately.³⁰

Administrative proceedings involving certain types of defective 1934 Act reports or filings³¹ are adjudicated pursuant to section 15(c)(4) of the 1934

25. See, e.g., Beneficial Labs, Inc., SEC 1933 Act Release No. 5598 (July 28, 1975); Bagels, U.S.A., Inc., SEC 1933 Act Release No. 5079 (Aug. 14, 1970); Isthmus S.S. & Salvage Co., 42 S.E.C. 257 (1964); American Beryllium & Oil Corp., 41 S.E.C. 616 (1963); Delta Steel Corp., SEC Ad. Pro. File No. 3-4495 (Dec. 3, 1974), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,031 (opinion of SEC ALJ).

26. 17 C.F.R. § 230.261 (1979).

27. Similar suspension proceedings may be, but are with much less frequency, litigated with regard to public offerings of securities allegedly exempt from registration by virtue of the provisions of Regulations B (fractional undivided interests in oil or gas rights), E (securities of small business investment companies), and F (assessable stock and assessments thereon).

28. 15 U.S.C. § 78o(b)(4), (6) (1976).

29. 15 U.S.C. § 78o-3, s(h) (1976). Prior to the 1975 Securities Act Amendments, 89 Stat. 79 (1975), such proceedings were litigated under former §§ 15(b)(5) and 15(b)(7) of the 1934 Act, 15 U.S.C. § 78o(b)(5), (7) (1970). See, e.g., Klopp v. SEC, 427 F.2d 455 (6th Cir. 1970); Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir.), cert. denied, 398 U.S. 958 (1970); Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); Beck v. SEC, 413 F.2d 832 (6th Cir. 1969), after remand, 430 F.2d 673 (6th Cir. 1970); Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Oppenheimer & Co., SEC 1934 Act Release No. 12,319 (Apr. 2, 1976), [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,551; Kidder, Peabody & Co., 43 S.E.C. 911 (1968). See generally Levine, Ferrara & Moylan, *supra* note 10. See also First Jersey Sec., Inc., SEC Ad. Pro. File No. 3-5739 (May 17, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,085 (order for public proceedings).

30. See Gellhorn, *Adverse Publicity by Administrative Agencies*, 86 HARV. L. REV. 1380, 1394-98 (1973).

31. See, e.g., United States Steel Corp., SEC 1934 Act Release No. 16,223 (Sept. 27, 1979); Spartek, Inc., SEC 1934 Act Release No. 15,567 (Feb. 14, 1979), [1979 Transfer

Act.³² Only reports filed pursuant to sections 13 and 15³³ are covered, such as annual or periodic reports or registration statements covering over-the-counter or exchange trading. Consequently, absent the consent of the respondent, defective proxy materials filed pursuant to section 14³⁴ or ownership reports filed pursuant to section 16,³⁵ cannot be the subject of section 15(c)(4) administrative proceedings. Technically, only registrants, not individuals, can be named respondents in a section 15(c)(4) proceeding. However, individuals have been so named in consent settlements.³⁶

Disciplinary proceedings against national stock exchanges are pursued under section 19 of the 1934 Act.³⁷ Disciplinary sanctions imposed by the National Association of Securities Dealers (NASD), stock exchanges, and other regulatory or quasi-governmental agencies or bodies are reviewable by the Commission on appeal pursuant to sections 15A, 15B, 17A, and 19 of the 1934 Act.³⁸

Summary suspensions of over-the-counter or exchange trading of a security are imposed by the SEC under sections 12(k) and 15(c)(5) of the

Binder] FED. SEC. L. REP. (CCH) ¶ 81,961; Woods Corp., SEC 1934 Act Release No. 15,337 (Nov. 16, 1978); Teledyne, Inc., SEC 1934 Act Release No. 15,266 (Oct. 23, 1978); Dominion Bankshares Corp., SEC 1934 Act Release No. 15,079 (Aug. 21, 1978); Texas Int'l Co., SEC 1934 Act Release No. 14,792 (May 23, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,605; International Tel. & Tel. Corp., SEC 1934 Act Release No. 14,049 (Oct. 13, 1977); Burlington N., Inc., SEC 1934 Act Release No. 13,480 (Apr. 28, 1977); Federated Purchaser, Inc., 44 S.E.C. 260 (1970); Crescent Corp., 43 S.E.C. 551 (1967).

32. 15 U.S.C. § 78o(c)(4) (1976).

33. 15 U.S.C. §§ 78m, 78o (1976).

34. 15 U.S.C. § 78n (1976).

35. 15 U.S.C. § 78p (1976).

36. *See, e.g.*, Government Employees Ins. Co. (Gidden & Peck), SEC 1934 Act Release No. 12,930 (Oct. 27, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,750.

37. 15 U.S.C. § 78s (1976). *See, e.g.*, San Francisco Mining Exch. v. SEC, 378 F.2d 162 (9th Cir. 1967); San Francisco Mining Exch., 42 S.E.C. 1004 (1966); San Francisco Mining Exch., 41 S.E.C. 560 (1963).

38. 15 U.S.C. §§ 78o-3, 78o-4, 78q-1, 78s (1976). *See, e.g.*, Stix & Co., SEC 1934 Act Release No. 12,760 (Sept. 2, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,722; Samuel A. Sardinia, SEC 1934 Act Release No. 12,392 (Apr. 29, 1976), [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,501; Thomas E. Jackson, SEC 1934 Act Release No. 11,476 (June 16, 1975), [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,213; Alfred D. Silverman, SEC 1934 Act Release No. 11,249 (Feb. 14, 1975); Charles E. Marland & Co., SEC 1934 Act Release No. 11,065 (Oct. 21, 1974), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,002; Don D. Anderson & Co., SEC 1934 Act Release No. 8477 (Dec. 26, 1968), *aff'd*, 423 F.2d 813 (10th Cir. 1970). *See generally* Lowenfels, *A Lack of Fair Procedures in the Administrative Process: Disciplinary Proceedings at the Stock Exchanges and the NASD*, 64 CORNELL L. REV. 375 (1979); Poser, *Reply to Lowenfels*, 64 CORNELL L. REV. 402 (1979); Note, *Governmental Action and the National Association of Securities Dealers*, 47 FORDHAM L. REV. 585 (1979). *See also* Silver v. NYSE, 373 U.S. 341 (1963); Ripp v. SEC, 591 F.2d 1344 (9th Cir. 1979); Intercontinental Indus., Inc. v. AMEX, 452 F.2d 935 (5th Cir. 1971), *cert. denied*, 409 U.S. 842 (1972).

1934 Act.³⁹ Exchange delisting of securities issues is reviewable by the Commission upon appeal pursuant to section 19 of the 1934 Act.⁴⁰

Pursuant to the 1934 Act, the Commission also adjudicates "re-entry" proceedings for individuals, who, having been disqualified from associating with a broker-dealer, attempt to have such disqualifications removed.⁴¹

C. The Advisers Act

Disciplinary proceedings concerning investment advisers and persons associated with investment advisers are adjudicated pursuant to section 203(e) of the Advisers Act.⁴²

D. The 1940 Act

Disciplinary proceedings and other adjudications concerning investment companies and persons associated therewith are adjudicated pursuant to sections 8, 9, and 41 of the 1940 Act.⁴³

39. 15 U.S.C. § 78l(k), 780(c)(5) (1976). Prior to the 1975 Securities Act Amendments, 89 Stat. 79 (1975), such summary trading suspensions were imposed pursuant to former § 15(c)(5) and § 19(a)(2), 15 U.S.C. §§ 78o(c)(5), 78s(a)(4) (1970). *See, e.g.*, SEC v. Sloan, 436 U.S. 103 (1978); Emersons, Ltd., SEC 1934 Act Release No. 12,320 (Apr. 7, 1976); Government Employees Ins. Co., SEC 1934 Act Release No. 12,125 (Feb. 23, 1976); Generics Corp. of America, SEC 1934 Act Release No. 12,027 (Jan. 19, 1976); Conrac Corp., SEC 1934 Act Release No. 12,026 (Jan. 16, 1976).

40. 15 U.S.C. § 78s (1976). *See, e.g.*, Intercontinental Indus., Inc., 44 S.E.C. 273 (1970), *aff'd sub nom.* Intercontinental Indus., Inc. v. AMEX, 452 F.2d 935 (5th Cir. 1971), *cert. denied*, 409 U.S. 842 (1972); Lee Motor Prods., Inc., 44 S.E.C. 33 (1969); Fifth Ave. Coach Lines, Inc., 43 S.E.C. 635 (1967); Magic Marker Corp., 43 S.E.C. 500 (1967); Fifth Ave. Indus. Corp., 43 S.E.C. 146 (1966); *cf.* Ludlow Corp. v. SEC, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,946 (D.C. Cir. Aug. 9, 1979) (unlisted trading privileges).

41. *See, e.g.*, NASD, Inc. (Shaub), 43 S.E.C. 1341 (1967); NASD, Inc. (Edelstein), 43 S.E.C. 479 (1967); NASD, Inc. (Truen), 42 S.E.C. 856 (1965).

42. 15 U.S.C. § 80b-3 (1976). *See, e.g.*, Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979); International Research & Mgt. Corp., SEC Advisers Act Release No. 617 (Mar. 6, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,547; Delphi Capital Corp., SEC Advisers Act Release No. 403 (Mar. 20, 1974); Schrott, Whitaker & Douglas, Inc., SEC Advisers Act Release No. 260 (Mar. 20, 1970); Mates Financial Servs., 44 S.E.C. 246 (1970); Kidder, Peabody & Co., 43 S.E.C. 911 (1968); Dow Theory Forecasts, Inc., 43 S.E.C. 821 (1968); Marketlines, Inc., 43 S.E.C. 267, *aff'd*, 384 F.2d 264 (2d Cir. 1967); Spear & Staff, Inc., 42 S.E.C. 549 (1965).

43. 15 U.S.C. §§ 80a-8, 80a-9, 80a-41 (1976). *See, e.g.*, Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979); Kimelman & Co., SEC 1940 Act Release No. 10,595 (Feb. 22, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,994; Investors Research Corp., SEC 1940 Act Release No. 10,223 (May 1, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,586; Carl L. Shipley, SEC 1940 Act Release No. 8394 (June 21, 1974), [1973-74 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,833; Waddell & Reed, Inc., SEC 1940 Act Release No. 7384 (Sept. 25, 1972), [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,049; Steadman Ameri-Fund, N.V., SEC 1940 Act Release No. 7378 (Sept. 22, 1972), [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,019; Chandler Mgt. Corp., SEC 1940 Act

E. Rule 2(e) Proceedings

The SEC adjudicates administrative disciplinary proceedings pursuant to rule 2(e) of the SEC's Rules of Practice⁴⁴ against attorneys, accountants, engineers, and other similar professionals who practice before the Commission or who may have some degree of involvement in securities transactions.⁴⁵ Although the securities statutes do not give the SEC explicit authority to discipline such professionals, the Commission contends that it

Release No. 7331 (Aug. 17, 1972), [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,978; First Multifund of America, Inc., 44 S.E.C. 680 (1971); A.V.C. Corp., 44 S.E.C. 134 (1970); Equity Corp., 44 S.E.C. 235 (1970); Fifth Ave. Coach Lines, Inc., 43 S.E.C. 635 (1967); Corroon & Reynolds Corp., 43 S.E.C. 295 (1967); Bowser, Inc., 43 S.E.C. 277 (1967); First Nat'l City Bank, 42 S.E.C. 924 (1966); M.A. Hanna Co., 42 S.E.C. 477 (1964); Townsend Corp. of America, 42 S.E.C. 282 (1964).

44. 17 C.F.R. § 201.2(e) (1979).

45. The pertinent literature includes: A. RAPPAPORT, SEC ACCOUNTING AND PRACTICE ch. 27, at 18-31 (1972); Bialkin, *Sanctions Against Accountants*, 8 REV. SEC. REG. 823 (1975); Burton, *supra* note 4; Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31 (1975); Garrett, *New Directions in Professional Responsibility*, 29 BUS. LAW. 7 (1974); Gonson, *Disciplinary Proceedings and Other Remedies Available to the SEC*, 30 BUS. LAW. 191 (1975); Johnson, *supra* note 10; Kemp, *Disciplinary Proceedings by the S.E.C. Against Attorneys*, 14 CLEV.-MAR. L. REV. 23 (1965); Sommer, *Accountants: A Flexible Standard*, 1 LITIGATION 35 (1975); Sonde, *Professional Responsibility — A New Religion, or the Old Gospel?*, 24 EMORY L. REV. 827 (1975); Sonde, *The Responsibility of Professionals Under the Federal Securities Laws — Some Observations*, 68 N.W.U.L. REV. 1 (1973); Wheat, *The Impact of SEC Professional Responsibility Standards*, 34 BUS. LAW. 969 (1979); Comment, *SEC Disciplinary Rules and the Federal Securities Laws: The Regulation, Role and Responsibilities of the Attorney*, 1972 DUKE L.J. 969; Jaenicke, *The Effect of Litigation on Independent Auditors*, Commission on Auditors' Responsibilities, Research Study No. 1, at 46-53 (AICPA 1977). Significant adjudications include: Kivitz v. SEC, 475 F.2d 952 (D.C. Cir. 1973), *rev'g* Murray A. Kivitz, 44 S.E.C. 600 (1971); SEC v. Ezrine, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,594 (S.D.N.Y. Aug. 2, 1972); Schwebel v. Orrick, 153 F. Supp. 701 (D.D.C. 1957), *aff'd*, 251 F.2d 919 (D.C. Cir.), *cert. denied*, 356 U.S. 927 (1958); Ernst & Ernst, SEC Accounting Series Release No. 248 (May 31, 1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,270; Haskins & Sells, SEC Accounting Series Release No. 241 (Feb. 10, 1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,263; Seidman & Seidman, SEC Accounting Series Release Nos. 196 (Sept. 1, 1976) and 196A (Nov. 18, 1976), 6 FED. SEC. L. REP. (CCH) ¶¶ 72,218-218A; Peat, Marwick, Mitchell & Co., SEC Accounting Series Release No. 173 (July 2, 1975), 6 FED. SEC. L. REP. (CCH) ¶ 72,195; Benjamin Botwinick & Co., SEC Accounting Series Release No. 168 (Jan. 13, 1975), 6 FED. SEC. L. REP. (CCH) ¶ 72,190; Westheimer Fine, Berger & Co., SEC Accounting Series Release No. 167 (Dec. 24, 1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,189; Arthur Anderson & Co., SEC Accounting Series Release No. 157 (July 8, 1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,179; Touche Ross & Co., SEC Accounting Series Release No. 153 (Feb. 25, 1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,175; Emanuel Fields, SEC 1933 Act Release No. 5404 (June 18, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,407; Laventhol, Krekstein, Horwath & Horwath, SEC Accounting Series Release No. 144 (May 23, 1973), 5 FED. SEC. L. REP. (CCH) ¶ 72,166; William R. Carter, SEC Ad. Pro. File No. 3-5464 (March 7, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175 (initial decision of SEC ALJ). *See also* Morris Mac Schwebel, 40 S.E.C. 347 (1960).

has implicit authority to do so. At least one federal appellate court has affirmed some degree of this authority.⁴⁶ Although rule 2(e) disciplinary proceedings consistently had been adjudicated privately for over 40 years, the Commission has recently litigated its first *public* rule 2(e) proceeding.⁴⁷

Rule 2(e) disciplinary proceedings have become somewhat controversial recently for at least two reasons. First, SEC Commissioner Roberta Karmel has taken an entrenched public position that the SEC lacks statutory authority to litigate such disciplinary proceedings.⁴⁸ Second, many practitioners and commentators believe that, even if the Commission does possess some degree of inherent or implied power to adjudicate administrative disciplinary proceedings against lawyers and accountants, the Commission is exceeding or misusing whatever power it has by administratively litigating cases involving conduct not falling within an attorney's or accountant's "practice before the Commission."⁴⁹

F. A Useful Substitute — Section 21(a) Public Reports of Investigation

Although not an *adjudicatory* enforcement tool, the SEC recently has been using another administrative enforcement-type procedure as a substitute for administrative disciplinary or civil injunctive proceedings in borderline or marginal cases—the section 21(a) "public report of investigation" and related section 21(a) "statements."⁵⁰ This substitute for traditional enforcement proceedings, however, has become somewhat controversial. SEC Commissioner Karmel has staked out an absolute po-

46. See *Touche Ross & Co. v. SEC*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,854 (2d Cir. May 10, 1979). But see *Keating, Muething & Klekamp*, SEC 1934 Act Release No. 15,982 (July 2, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124 at 81,992 (SEC Commissioner Karmel, dissenting).

47. See *Touche Ross & Co.*, SEC Ad. Pro. File No. 3-5079 (Sept. 2, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,720 (order for public proceedings). See also *Touche Ross & Co.*, 438 F. Supp. 259 (S.D.N.Y. 1977), *aff'd*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,854 (2d Cir. May 10, 1979); *Touche Ross & Co.*, SEC Accounting Series Release No. 153 (Feb. 25, 1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,175.

48. See *Keating, Muething & Klekamp*, SEC 1934 Act Release No. 15,982 (July 2, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124. See also *Daley & Karmel, Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 EMORY L.J. 747 (1975).

49. See, e.g., the following *amicus curiae* briefs filed in the pending *Carter-Johnson* rule 2(e) case: (i) *Sullivan & Cromwell* (July 18, 1979) at 13-14; (ii) *Michael R. Klein* (July 12, 1979) at 10-13; (iii) *ABA Section of Corporation, Banking and Business Law* (July 3, 1979) at 9-10; and (iv) *Arthur F. Mathews* (Aug. 7, 1979) at 6-7.

50. Section 21(a) of the 1934 Act states in pertinent part:

The Commission may . . . make such investigations as it deems necessary to determine whether any person has violated . . . any provision of this chapter, the rules and regulations thereunder, . . . and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investi-

sition in opposition to the remaining SEC Commissioners, contending that it is improper to resolve enforcement cases in settlements embracing publication of section 21(a) reports or statements.

Thus, dissenting in *Spartek, Inc.*⁵¹, Commissioner Karmel stated:

I object to the use of Section 21(a) as an alternative administrative remedy against persons who allegedly violate the securities laws. In particular, it should not be used to take administrative

gated. The Commission is authorized in its discretion, to publish information concerning any such violations

15 U.S.C. § 78u(a) (1976).

See Crowell Collier Publishing Co., SEC Act Release No. 3825 (Aug. 12, 1957), [1957-61 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,539; Drayer-Hanson, Inc., 27 S.E.C. 838 (1948); Ward La France Truck Corp., 13 S.E.C. 373 (1943); Allegheny Corp., 6 S.E.C. 960 (1940); McKesson & Robbins, SEC Accounting Series Release No. 19 (Dec. 5, 1940), 5 FED. SEC. L. REP. (CCH) ¶ 72,020; *SEC Staff Study of the Financial Collapse of the Penn Central Company* (1972), [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,931; SEC Report of Investigation, *In re Disclosures by Registrants Engaged in Defense Contracting*, SEC Ad. Pro. File No. 3-2485 (1972); SEC STAFF REPORT ON ORGANIZATION, MANAGEMENT, AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE (1962). *See generally* Marine Protein Corp. Indus. Dev. Revenue Bonds, SEC 1934 Act Release No. 15,719 (April 11, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,049; Greater Wash. Inv., Inc., SEC 1934 Act Release No. 15,673 (Mar. 22, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,032; Spartek, Inc., SEC 1934 Act Release No. 15,567 (Feb. 14, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,961; National Tel. Co., SEC 1934 Act Release No. 14,380 (Jan. 16, 1978), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,410; Sterling Drug, Inc., SEC 1934 Act Release No. 14,675 (April 18, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,570; Gould, Inc., SEC 1934 Act Release No. 13,612 (June 9, 1977), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,077; Burlington N., Inc., SEC 1934 Act Release No. 13,480 (April 28, 1977); Government Employees Ins. Co., SEC 1934 Act Release No. 12,930 (Oct. 27, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,750; Statement Submitted by Vance, Sanders & Co., Inc., SEC 1934 Act Release No. 15,746 (April 19, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,058; Statement Submitted by Robert K. Lifton and Howard Weingrow, SEC 1934 Act Release No. 15,665 (March 21, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,015; THE COMMISSION'S PRACTICE RELATING TO REPORTS OF INVESTIGATIONS AND STATEMENTS SUBMITTED TO THE COMMISSION PURSUANT TO SECTION 21(A) OF THE SECURITIES AND EXCHANGE ACT OF 1934, SEC 1934 Act Release No. 15,664 (March 21, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,014; TRANSACTIONS IN THE SECURITIES OF THE CITY OF NEW YORK: FINAL REPORT (Feb. 5, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,936; SEC STAFF REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK (Aug. 26, 1977), 418 SEC. REG. & L. REP. (BNA) E-1; SEC REPORT OF INVESTIGATION IN THE MATTER OF STIRLING HOMEX CORP. RELATING TO ACTIVITIES OF THE BOARD OF DIRECTORS OF STIRLING HOMEX CORP. (outside directors Kheel and Castellucci), SEC 1934 Act Release No. 11,516 (July 2, 1975), [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,219; SEC REPORT OF INVESTIGATION ON THE LOCKHEED AIRCRAFT CORP. (SEC 1975); PUBLIC INVESTIGATION CONCERNING DISCLOSURES BY REGISTRANTS ENGAGED IN DEFENSE CONTRACTING (Lockheed investigation) SEC Minute, (September 11, 1970), [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,905.

51. SEC 1934 Act Release No. 15,567 (Feb. 14, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,961.

action against persons not subject to the Commission's jurisdiction under Section 15 of the Exchange Act. I object even more strenuously to the use of Section 21(a) as an enforcement vehicle to publicize facts which do not constitute violations of the securities laws. The Commission has express statutory provisions under which it must proceed to determine whether violations have occurred and what sanctions should be imposed. Once those findings are made, the Commission then may publish information about these violations under Section 21(a) for the purposes enumerated therein. Using Section 21(a) instead of invoking express statutory procedures I believe is improper.⁵²

Commissioner Karmel also dissented from the issuance of a public section 21(a) statement written by Robert K. Lifton and Howard Weingrow,⁵³ from a contemporaneous SEC interpretive release entitled *The Commission's Practice Relating to Reports of Investigations and Statements Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of 1934*,⁵⁴ from the section 21(a) statement in *Vance, Sanders & Company, Inc.*,⁵⁵ and from a section 21(a) report in *Marine Protein Corporation*

52. *Id.* at 81,410 (footnotes omitted).

53. SEC 1934 Act Release No. 15,665 (Mar. 21, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,015, at 81,559-61:

I object to the issuance of this negotiated statement from two individuals, because I do not believe that publication based on Section 21(a) of the . . . 1934 [Act] . . . should be used as a sanction to dispose of investigated matters. I am particularly disturbed by such publication where, as here, the Commission could not institute formal administrative proceedings under Section 15(b) of the Act against the persons who submitted the statement. The facts in the letter do not clearly constitute a violation of the securities laws and the Commission has not concluded a violation has occurred.

Id. at 81,561.

54. SEC 1934 Act Release No. 15,664 (Mar. 21, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,014, at 81,557-59:

In my view, publication by the Commission under Section 21(a) of a negotiated statement by a person under investigation setting forth admissions and undertakings constitutes, in effect, a sanction. Moreover, the publication would not necessarily announce a Commission determination as to whether or not the facts set forth in the submitted statements constitute a violation of the securities laws. I do not believe the imposition of a sanction is proper unless the Commission makes such a determination and then announces it. It is wrong for a government prosecutor to impose sanctions based on factual admissions, as contrasted to violations of law. If the Commission is unwilling to authorize administrative or injunctive proceedings based on the facts uncovered in an enforcement investigation, it should exercise its prosecutorial discretion by simply terminating the investigation.

Id. at 81,559 (footnotes omitted).

55. SEC 1934 Act Release No. 15,746 (April 18, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,058, at 81,701-05:

*Industrial Development Revenue Bonds.*⁵⁶

Nevertheless, the majority of the Commission's members, as well as its enforcement staff, continue to recognize and use section 21(a) reports and statements as an important enforcement alternative.⁵⁷

III. DISCIPLINARY NATURE OF SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

The most common type of administrative enforcement proceeding adjudicated by the Commission is the 1934 Act broker-dealer disciplinary proceeding. Investment adviser adjudicatory proceedings under the Advisers Act and investment company disciplinary proceedings under the 1940 Act, although less frequently used, are comparable to 1934 Act broker-dealer proceedings. Rule 2(e) proceedings involving attorneys, accountants, engineers, or other professionals who practice before the Commission are similar in many procedural respects. Each of these administrative enforcement proceedings is disciplinary in nature, embraces the possible imposition of

I object to the publication of negotiated statements based upon Section 21(a) . . . to settle an enforcement matter where, as here, no proceeding authorized under the securities laws has been instituted by the Commission . . . In this case, the utilization of publication under Section 21(a) to terminate this investigation was unnecessary and inappropriate because the Commission has express administrative authority to sanction the persons involved. . . .

The Commission's policies with respect to the filings of schedule 13G forms by an investment adviser to a complex of funds were previously enunciated in a release last year. Any disciplinary sanctions which the Commission believed were appropriate to impose for the failure of Vance, Sanders . . . to file Schedule 13D forms . . . should have been imposed in a traditional adjudicatory proceeding. *The procedure employed here encourages the formulation of regulatory policy by way of the Commission's prosecutorial powers to the detriment of the Commission's rulemaking and adjudicatory functions.*

Id. at 81,703 (footnotes omitted, emphasis supplied).

56. SEC 1934 Act Release No. 15,719 (Apr. 11, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,049, at 81,685.

57. The Commission's Practice Relating To Reports Of Investigations and Statements Submitted To The Commission Pursuant To Section 21(a) Of The Securities Exchange Act of 1934, SEC 1934 Act Release No. 15,664 (Mar. 21, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,014, at 81,557-59:

The Commission today affirms its intention to continue its practice of issuing such [Section 21(a)] reports in appropriate instances . . . [Also], the Commission will utilize [Section 21(a) statements] where it appears to be appropriate in the public interest and the special circumstances of the case. Thus, the Commission may allow persons who have been involved in investigative proceedings, as part of the process of resolving their involvement in the investigation, to submit statements in acceptable form with the expectation that the Commission may make the statements public.

Id. at 81,557-58 (footnotes omitted).

severe sanctions, and consequently is "penal" or "quasi-criminal" in effect, despite the Commission's longstanding argument that its administrative proceedings are "remedial," not "penal."⁵⁸

The disciplinary sanctions that may be imposed against persons and entities in broker-dealer proceedings include: outright revocation of license (or denial of registration); bar from association with a broker-dealer; suspension of license or association for a period up to one year; the placing of limitations on the activities or functions of a person or entity; or censure.⁵⁹ Advisers Act and 1940 Act sanctions are comparable.⁶⁰ In contrast, rule 2(e) sanctions are limited to a suspension or bar from practice before the Commission.⁶¹

Neither the 1934 Act, the Advisers Act, the 1940 Act, nor the statutory underpinnings of rule 2(e) gives the Commission statutory authority in administrative disciplinary proceedings to obtain ancillary relief, such as disgorgement or restitution. Ancillary relief, however, is sometimes obtained by consent in settlement dispositions of administrative disciplinary ac-

58. Former SEC General Counsel, and now Second Circuit Judge, Timbers has labeled SEC disciplinary proceedings "quasi-punitive." See Timbers & Garfinkel, *supra* note 4, at 824. The modern judicial trend is in accord. See, e.g., *Steadman v. SEC*, 603 F.2d 1126, 1139 (5th Cir. 1979) ("exclusion from the industry is clearly a penalty"); *Collins Sec. Corp. v. SEC*, 562 F.2d 820, 825 (D.C. Cir. 1977) (punitive as well as remedial); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 n.6 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978) (revocation has significant penal component). In the trial of the signal *Collins Securities* case, in which the writer was trial counsel, the SEC administrative law judge conceded that 1934 Act broker-dealer administrative disciplinary proceedings were "quasi-criminal" in nature. Cf. *In re Buffalo*, 390 U.S. 544, 550-51 (1968) (although disbarment of lawyer designed to protect public, it is also a punishment imposed on the individual); *Spevak v. Klein*, 385 U.S. 511, 514-16 (1967) (disbarment is a penalty such that right against self-incrimination attaches and person cannot be punished for invoking it); *Charlton v. FTC*, 543 F.2d 903, 906 (D.C. Cir. 1976) (contrary to the FTC's concept, disciplinary proceedings are adversary proceedings of a quasi-criminal nature). But see *Blaise D'Antoni & Assoc. v. SEC*, 289 F.2d 276, 277 (5th Cir. 1961) (revocation of broker-dealer registration held not to be a penalty).

59. For example, § 15(b)(4) of the 1934 Act states, in part:

The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest . . . [and a willful violation or other statutory disqualification is proven].

15 U.S.C. § 78o(b)(4) (1976).

For an analysis of the sanctioning process in broker-dealer cases, see the trilogy of articles by Professor Thomforde: Thomforde, *Patterns of Disparity in SEC Administrative Sanctioning Practice*, 42 TENN. L. REV. 465 (1975); Thomforde, *supra* note 4; Thomforde, *supra* note 10.

60. See § 203(e) of the Advisers Act, 15 U.S.C. § 80b-3(e) (1976).

61. 17 C.F.R. § 201.2(e) (1979).

tions.⁶² Moreover, the Commission does not have the statutory power to impose administrative fines and does not do so even in consent settlements.⁶³

Although the Commission has the authority to institute public or private proceedings under the 1934, Advisers, and 1940 Acts, the overwhelming majority of such proceedings in the 1970's have been public.⁶⁴

The initial pleading entered by the Commission and formally commencing the proceeding is the "Order for Proceedings." This order identifies the respondents and contains a description of the alleged statutory violations to be adjudicated.⁶⁵ All procedures for the adjudication, including

62. See, e.g., Bateman Eichler, Hill Richards, Inc., SEC 1934 Act Release No. 14,579 (Mar. 20 1978); Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC 1934 Act Release No. 14,149 (Nov. 9 1977), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,365; Government Employees Ins. Co., SEC 1934 Act Release No. 12,930 (Oct. 27, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,750; Financial Programs, Inc., SEC 1934 Act Release No. 11,312 (Mar. 24, 1975), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,146; Kippen & Co., SEC 1934 Act Release No. 10,935 (July 30, 1974); Continental Inv. Corp., SEC 1940 Act Release No. 8556 (Oct. 24, 1974); The First Nat'l Bank of Boston, SEC 1940 Act Release No. 7859 (June 13, 1973); Butcher & Sherrerd, SEC 1934 Act Release No. 9894 (Dec. 11, 1972), [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,135; Statement Submitted by Robert K. Lifton & Howard Weingrow, SEC 1934 Act Release No. 15,665 (Mar. 21, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,015. See generally Sporkin, *SEC Developments in Litigation and the Molding of Remedies*, 29 BUS. LAW. 121 (1974).

63. The Commodities Futures Trading Commission, whose organization in many respects has been patterned along the lines of the SEC, does have specific statutory authority to impose administrative fines. See Commodities Exchange Act, §§ 6(c), 14, 7 U.S.C. §§ 13b, 18 (1976). The "Wells Committee" that studied SEC enforcement policies, practices, and procedures in 1972 recommended that the SEC seek from Congress the authority to impose monetary fines as administrative sanctions. To date, the Commission has not done so. See SEC REPORT OF THE ADVISORY COMMITTEE ON ENFORCEMENT POLICIES AND PRACTICES 30 (1972), reprinted in A. MATHEWS, *SECURITIES LITIGATION UNDER THE FEDERAL SECURITIES LAWS — 1977* 239-321 (P.L.I. 1977). See also Lloyd Sabando, S.A. v. Elting, 287 U.S. 329 (1932); 1 K. DAVIS, *ADMINISTRATIVE LAW TREATISE* §§ 2.13, 4.05 (1958); Goldschmid, *An Evaluation of the Present and Potential Use of Civil Money Penalties as a Sanction by Federal Administrative Agencies* in 2 RECOMMENDATIONS AND REPORTS OF THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES 896 (1972).

64. For an enumeration of the factors supposedly considered by the Commission and its Enforcement Staff in determining whether a particular proceeding will be adjudicated publicly or privately, see Internal SEC Staff Memorandum from Stanley Sporkin, then Assistant Director (Enforcement), Division of Trading and Markets, to all SEC Regional Offices (August 23, 1967), reprinted in Gellhorn, *supra* note 30, at 1397-98 n.64. For the author's views as to why all SEC administrative disciplinary proceedings, including rule 2(e) proceedings should be public, see Letter from A.F. Mathews to SEC Advisory Committee on Enforcement Policies and Practices (May 23, 1972), reprinted in MATHEWS, *supra* note 63, at 323.

65. For examples of orders for proceedings, see First Jersey Sec., Inc., SEC Ad. Pro. File No. 3-5739 (May 17, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,085; Boston Co. Inst. Inv., Inc. (Dirks-Equity Funding), SEC Ad. Pro. File No. 3-5068 (Aug. 24, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,729; Touche Ross & Co.,

the conduct of the hearing, and pretrial and posttrial briefing and motions practice are governed by the SEC's Rules of Practice.⁶⁶ An independent SEC administrative law judge is the adjudicator at the hearing.⁶⁷

IV. SEC STAFF BURDENS

The interested division or office of the Commission — typically the Enforcement Division — is the plaintiff in an administrative disciplinary proceeding. As such, it must introduce sufficient proof, judged by the appropriate standard for weighing and considering the evidence, to establish that each respondent is responsible for one or more violations of law. In addition to proof of a statutory violation, the interested division must establish that the violation was "willful" and that it is necessary and appropriate "in the public interest and for the protection of investors" before a sanction can be imposed against a particular respondent.⁶⁸

A. Burden of Proof: What is The Proper Standard?

Historically, the SEC has applied the "preponderance of the evidence" standard of proof in the adjudication of administrative disciplinary proceedings.⁶⁹ However, in a landmark administrative law decision in 1977, *Collins Securities Corp. v. SEC*,⁷⁰ the United States Court of Appeals for the District of Columbia Circuit held that in the adjudication of fraud charges by the SEC in administrative disciplinary proceedings, where severe sanctions with extremely serious consequences can be imposed, the more stringent "clear and convincing evidence" standard is required.

In *Collins*, the court was concerned with the inferential, as opposed to direct, nature of the alleged proof of manipulation:

Although we have confidence that the SEC can utilize inferential evidence in a proper and responsible manner, the fact remains that such evidence is at least somewhat weaker and less

SEC Ad. Pro. File No. 3-5075 (Sept. 2, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,720 (rule 2(e) proceeding).

66. 17 C.F.R. §§ 201.1 to .27 (1979). The Rules of Practice must be distinguished from the SEC's Rules Relating to Investigations, 17 C.F.R. §§ 203.1 to .8 (1979), which are much less detailed and govern the conduct of SEC investigations.

67. See Hearing Examiners Now Called Administrative Law Judges, SEC 1933 Act Release No. 5311 (Sept. 27, 1972), [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,014.

68. See, e.g., § 15(b)(4) of the 1934 Act, *quoted in part*, note 59 *supra*.

69. See, e.g., Norman Pollisky, 43 S.E.C. 458, 459-60 (1967); James De Mammos, 43 S.E.C. 333, 337 (1967), *aff'd mem.* (2d Cir., Oct. 13, 1967); Harris, Clare & Co., Inc., 43 S.E.C. 198 (1966); Underhill Sec. Corp., 42 S.E.C. 689 (1965).

70. 562 F.2d 820 (D.C. Cir. 1977).

reliable than direct evidence of violations. In addition, the use of inferences, which is dependent on the exercise of discretion by an administrative agency and not a court, can, as in this case, lead to drastic sanctions which in effect amount to a deprivation of livelihood for the sanctioned parties.⁷¹

Of great concern to the court was the "punitive" or penal effect of the SEC's so-called "remedial" sanctions.⁷² Although acknowledging the SEC's assertion that broker-dealer administrative proceedings are "remedial" in nature, the court nevertheless held that they are also "penal" in effect:

Such labels are likely to reflect conclusions rather than analyses, and in any event are not determinative. In one sense, both labels are correct. From the point of view of the public and enforcement agency, the action of the SEC is "remedial." To the broker removed from his profession the action partakes of "punitive" impact. One would hardly say that removal of a robber from society should be classed as only "remedial," because it protects ordinary citizens from his probable repetition of the crime. The clear and convincing standard has been evolved in fraud cases as a balance — protecting the defrauded, and also protecting one faced with the surcharge of damages imposed for fraud.⁷³

The *Collins* decision is significant and should have a noticeable effect on SEC disciplinary adjudications. SEC administrative law judges are now applying the "clear and convincing evidence" standard and in a few cases have dismissed fraud charges due to the enforcement staff's failure to sat-

71. *Id.* at 823. The court added:

The fact that such consequences can flow from an inferential mode of reasoning exercised by an administrative agency forms in large part our concern over the standard of proof to which these inferences are to be put. Thus, while we recognize the need to draw inferences to support allegations of security law violations, we discern a need to subject such evidence to a standard which will ensure that any remedial sanctions are imposed only in those circumstances where the evidence is of such a quality as to make the sanctions appear just and reasonable.

Id.

72. Traditionally, the SEC has justified its departure in administrative disciplinary proceedings from more stringent burdens or procedures applicable to judicial proceedings vindicating solely private rights, by labeling the purpose of its administrative proceedings "remedial" — to protect the public interest, as opposed to "penal" — to punish an individual for past misconduct. *See, e.g.,* *Berko v. SEC*, 316 F.2d 137, 141 (2d Cir. 1963); *Blaise D'Antoni & Assoc., Inc. v. SEC*, 289 F.2d 276, 277 (5th Cir. 1961); *Pierce v. SEC*, 239 F.2d 160, 163 (9th Cir. 1956). However, courts are beginning to point out the truly "penal" nature of SEC administrative disciplinary sanctions. *See* note 58 *supra*. *See also* *United States v. Lovett*, 328 U.S. 303 (1946); *Bailey v. Richardson*, 182 F.2d 26 (D.C. Cir.), *aff'd by an equally divided court* 341 U.S. 918 (1950).

73. 562 F.2d at 825.

isfy the more stringent clear and convincing burden.⁷⁴ Thus, the Commission can be expected to reduce sanctions in cases where courts remand a matter to the agency for reassessment in light of the *Collins* ruling.⁷⁵ Furthermore, the Court of Appeals for the District of Columbia Circuit recently warned the Commission in a post-*Collins* case, *Whitney v. SEC*,⁷⁶ that it will not tolerate the Commission's being "overly parsimonious" in accepting and applying the "clear and convincing" test.⁷⁷

However, the *Collins* case is *not* all encompassing. It purports to require the clear and convincing standard only in adjudications in which fraud is charged and the sanctions to be imposed are severe. It does not purport to apply to all SEC disciplinary actions:

Whether a lesser sanction, say, probation or warning, may be satisfied with a lesser standard — an approach that would present some logical difficulties yet seem to harmonize with common sense — is an issue we need not resolve in this case. Nor do we insist on the "clear and convincing" standard in other than fraud cases; our ruling is confined to this case involving the typical circumstantial proof of a fraud case and resulting in the severe sanction of deprivation of livelihood.⁷⁸

The United States Court of Appeals for the Fifth Circuit, in *Steadman v. SEC*,⁷⁹ recently refused to adopt across-the-board the *Collins* "clear and convincing" standard in SEC administrative disciplinary proceedings brought against an investment adviser pursuant to the Advisers and 1940 Acts.⁸⁰ Nevertheless, *Steadman* is important respecting the burden of proof in SEC administrative disciplinary proceedings for two separate reasons: First, it introduces a new "compelling reasons" or "burden of justifi-

74. See, e.g., Allen & Co., SEC Ad. Pro. File No. 3-5258 (Aug. 2, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,174, at 82,149 n.7 (initial decision of SEC ALJ).

75. See, e.g., Nasser & Co., Inc., SEC 1934 Act Release No. 15,347 (Nov. 22, 1978), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,094, *on remand from* Nasser v. SEC, 566 F.2d 790 (D.C. Cir. 1977); cf. John P. Decker, SEC Ad. Pro. File No. 3-4976 (Dec. 5, 1977), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,338 (application of *Collins* "clear and convincing" standard when conduct alleged was breach of fiduciary duty).

76. 604 F.2d 676 (D.C. Cir. 1979).

77. The court reprimanded the SEC as follows:

Evidently, however, the Commission is of the view that *Collins* is either wrong or inapposite. We disagree. *Collins*, which we reaffirm today, plainly governs this case [T]he Commission has taken an overly parsimonious view of our rationale in *Collins*; we hold here that any sanction imposed under § 15(b) which depends on a finding of fraud must be sustained by clear and convincing evidence.

Id. at 680-81 (footnotes omitted).

78. *Collins Sec. Corp. v. SEC*, 562 F.2d at 825 n.32.

79. 603 F.2d 1126 (5th Cir. 1979).

80. See notes 42-43 and accompanying text *supra*.

cation” test for imposition of sanctions by the SEC — a test that is favorable to respondents and places a stringent burden on the SEC.⁸¹ Second, the *Steadman* court left open the possibility that proof by more than the traditional “preponderance” test may be required in cases embracing the type of fraud charges that demand proof of scienter as an element of the violation.⁸² Thus, the *Steadman* court highlighted the importance for defense counsel to address both the burden of proof imposed upon the SEC staff to establish the particular statutory violations alleged and the factual showing necessary to support harsh sanctions once a statutory violation has been established.

In *Steadman*, the court held that the SEC need not prove scienter to establish violations of subsections 17(a)(2) and (3) of the 1933 Act⁸³ and subsection 206(2)⁸⁴ of the Advisers Act.⁸⁵ When scienter is not required, these statutory provisions essentially provide for negligence liability even though they fall within the rubric of what are generally described as “anti-fraud” provisions of the federal securities laws. Since such a “remedial” construction of these provisions removes them from the ambit of traditional fraud allegations where intent must usually be proven circumstantially, the court advanced the view that the *Collins* “clear and convincing” test was not necessary, and that the traditional “preponderance” test would suffice.⁸⁶ There is certainly room within the court’s holding in *Steadman* for it to require the “clear and convincing” test in cases involving section

81. 603 F.2d at 1139-40.

82. *Id.* at 1138-39.

83. 15 U.S.C. §§ 77q(a)(2), (3) (1976).

84. 15 U.S.C. § 80b-6(2) (1976).

85. 603 F.2d at 1138-39. On the other hand, the court held that the SEC must prove scienter to establish violations of § 17(a)(1) of the 1933 Act, 15 U.S.C. § 77q(a)(1) (1976), and § 206(1) of the Advisers Act, 15 U.S.C. § 80b-6(1) (1976). *Id.* at 1143.

86. The court pointed out:

To the extent that *Collins* rests on a concern that there are particular risks for a respondent in a fraud proceeding because the proof is necessarily circumstantial and inferential, we are not persuaded. In this proceeding, the only fact to which *Steadman* points as being based on disputed inferences is his state of mind — whether he acted with an intent to defraud. But we have held that scienter is not an element of a violation of subsections (2) and (3) of section 17(a) of the Securities Act or of section 206(2) of the IAA, statutes on which the Commission relies to a significant degree in this case. These are commonly called “antifraud” provisions, but the offenses they define are fraud in the broadest “remedial” sense of that term and require no showing of intent to injure or injury. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) The facts necessary to establish a violation of these sections — nondisclosure of a material fact — are capable of proof by ordinary direct or circumstantial evidence as in any other administrative proceeding.

603 F.2d at 1138-39.

17(a)(1) of the 1933 Act,⁸⁷ rule 10b-5 under the 1934 Act,⁸⁸ section 206(1) of the Advisers Act,⁸⁹ and other sections of the federal securities laws that require scienter.

But the main reason why *Steadman* is just as important to defense lawyers litigating SEC administrative enforcement proceedings as *Collins* and *Whitney* is the new "compelling reasons" or "burden of justification" test now applicable in the Fifth Circuit to the imposition of sanctions. The court explained its reasons for adopting this test as follows:

[I]mposing a high burden of persuasion to establish the facts of a securities-laws violation is not the only means to protect a respondent. We are empowered to set aside Commission orders that are arbitrary and capricious. 5 U.S.C. §§ 551, 702, 706 (1976). We subscribe to the common-sense notion that *the greater the sanction the Commission decides to impose, the greater is its burden of justification*. Where, as here, the most potent weapon in the Commission's "arsenal of flexible enforcement powers," . . . is used, the Commission has an obligation to explain why a less drastic remedy would not suffice. . . . In our view, however, *permanent exclusion from the industry is "without justification in fact unless the Commission specifically articulates compelling reasons for such a sanction."*⁹⁰

The *Steadman* court succinctly stated its "compelling reasons" or "burden of justification" test at the close of its opinion: "When the Commission imposes the most drastic sanctions at its disposal, it has a duty to articulate carefully the grounds for its decision, including an explanation of why lesser sanctions will not suffice."⁹¹

87. 15 U.S.C. § 77q(a)(1) (1976).

88. 17 C.F.R. § 240.10b-5 (1979).

89. 15 U.S.C. § 80b-6(1) (1976).

90. 603 F.2d at 1139-40 (footnote omitted, emphasis supplied).

91. The court mentioned some of the factors which the SEC might look to in justifying the sanction of bar: (i) facts indicating a reasonable likelihood that a particular violator cannot ever operate in compliance with the law, *see SEC v. Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978); (ii) violations so egregious that even if further statutory violations are unlikely the nature of the conduct mandates permanent debarment as a deterrent to others in the industry, *see Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 184 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978); *cf. Beck v. SEC*, 430 F.2d 673, 674-75 (6th Cir. 1970) (sanction must be necessary to deter respondent); and (iii) the factors relevant to the issuance of an injunction including:

the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

SEC v. Blatt, 583 F.2d at 1334 n.29. *See* 603 F.2d at 1140.

When considering burden of proof and analyzing *Steadman, Collins*, and *Whitney*, a further point is pertinent. Even though other circuits have not yet squarely addressed the *Collins* holding, its importance cannot be minimized since all administrative disciplinary sanctions imposed by the SEC may be appealed to the District of Columbia Circuit.⁹² Presumably, because of this the SEC has recently asked Congress to overrule the *Collins* case in new legislation.⁹³ Certainly, in *Whitney*, the District of Columbia Circuit has demonstrated that it will not be sympathetic to Commission attempts to circumvent the "clear and convincing" requirement.

In *Whitney*, the Commission contended that the *Collins* "clear and convincing" standard did not apply because the nine-month suspension in *Whitney* was not a "severe" sanction as was the revocation and bar in *Collins*, and the "direct" evidence in *Whitney* had a "naturally greater persuasion" than the "circumstantial" evidence in *Collins*. The court, however, expressly rejected both supposed distinctions.⁹⁴

The court further cautioned that (i) absent specific enumeration of the factors justifying permanent exclusion, "To say that past misconduct gives rise to an inference of future misconduct is not enough," 603 F.2d at 1140, and (ii) state of mind, that is, the presence or absence of scienter, is "highly relevant in determining the remedy to impose. It would be a gross abuse of discretion to bar an investment advisor from the industry on the basis of isolated negligent violations." *Id.* at 1140-41.

92. See, e.g., § 25 of the 1934 Act, 15 U.S.C. § 78y (1976).

93. The SEC filed a memorandum with the Senate Governmental Affairs Committee in July 1979 opposing two regulatory reform bills (S. 262 and S. 755) unless they are amended, in among other respects, to overrule the *Collins* case by specifically providing that the "preponderance of the evidence" standard of proof shall govern SEC adjudicatory proceedings. See 513 SEC. REG. & LAW REP. (BNA) at A-1 (1979).

The *Collins* "clear and convincing" evidence rule probably will not be limited to SEC proceedings. The question of its applicability to administrative disciplinary proceedings adjudicated by the Commodities Futures Trading Commission, for example, has already been raised. In one pending case, *Compania Salvadorena de Cafe, S.A.*, CFTC Docket No. 79-34, the CFTC Chief Administrative Law Judge has determined to apply the *Collins* test. See 518 SEC. REG. & L. REP. (BNA) A-1 (Aug. 29, 1979).

94. The court stated:

These supposed distinctions do not matter. . . . Like the revocation in *Collins*, a suspension for nine months imposes a serious loss, both as a short-run matter of foregone business, and, perhaps more grievously, as a permanent injury to reputation. Any supposed difference in this respect is one of degree which we think, immaterial to the adequate measure of proof. Moreover, despite the presence of some "direct" testimony in this case, the state of the evidence is hardly unequivocal and we are reluctant to forego the added assurance of correctness afforded by a heightened standard of proof.

604 F.2d at 681. The court added, "[W]e intend the word 'fraud' not merely in its common law sense, but comprehending all violations of § 10(b) and rule 10b-5." *Id.* at 681 n.19. See also *Collins Sec. Corp. v. SEC*, 562 F.2d 820, 824 (D.C. Cir. 1977) (the "clear and convincing evidence" standard has been imposed in hundreds of civil fraud cases).

Collins, *Whitney*, and *Steadman*, read together, demonstrate that modern courts will carefully scrutinize the SEC's imposition of severe sanctions and will not uphold severe disciplinary penalties upon a tenuous evidentiary basis.

Defendants' counsel, however, should be cognizant of a further aspect of burden of proof. Despite the fact that *Collins* and its progeny mandate proof by "clear and convincing" evidence to support harsh administrative sanctions, the United States Court of Appeals for the District of Columbia Circuit recently held in *SEC v. Savoy Industries, Inc.*,⁹⁵ that in a civil injunctive action the SEC need only prove its case by a preponderance of the evidence.⁹⁶ In *Savoy*, the court refused to adopt the *Collins* "clear and convincing" test in an injunctive action involving reporting violations of section 13(d) of the 1934 Act.⁹⁷ Whether the court would reach the same result in an injunctive action alleging fraud is open to question. Nevertheless, under sections 15(b)(4) and (6) of the 1934 Act,⁹⁸ the SEC can administratively bar or suspend a person from associating with or registering as a broker-dealer based solely on establishment that the person has been "permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction . . . from engaging in or continuing any conduct or practice" in connection with any securities activity.⁹⁹

Conceivably, a person could be first enjoined through application of the preponderance standard, and then barred by virtue of the statutory disqualifications of sections 15(b)(4) and (6), even though the "clear and convincing" test would have to be satisfied if a direct administrative disciplinary proceeding had been brought involving the same conduct. If the courts do not ultimately adopt the "clear and convincing" standard for injunctive actions, this unfair anomaly could nevertheless be prevented if appellate courts would apply the *Steadman* "compelling reasons" or "burden of justification" test whenever administrative disciplinary sanctions are imposed.¹⁰⁰

B. Willfulness

1. Generally

Over the years the Commission has practically read the "willfulness" requirement out of the securities statutes in administrative disciplinary

95. 587 F.2d 1149 (D.C. Cir. 1978).

96. *Id.* at 1168-69.

97. 15 U.S.C. § 78m(d) (1976).

98. 15 U.S.C. § 78o(b)(4), (6) (1976).

99. 15 U.S.C. § 78o(b)(4)(C) (1976).

100. See notes 79-91 and accompanying text *supra*.

proceedings. It has consistently maintained that the word "willful," as used in the 1934 Act, does not require a finding that the respondent *knows* that his conduct violates the law, intends to violate the law, or even has actual or constructive knowledge that the law is being violated. The Commission must only find that the respondent's conduct is neither unintentional nor inadvertent.¹⁰¹

Nevertheless, there is one Commission opinion, *International Shareholders Services Corp.*,¹⁰² that may be useful to defense counsel in those relatively infrequent cases in which establishment of even the SEC's diluted concept of willfulness may be tenuous. There, the Commission reversed an administrative law judge's finding that a broker-dealer willfully violated the registration provisions of section 5 of the 1933 Act¹⁰³ in connection with an intrastate offering of securities when a section 3(a)(11) exemption from registration was claimed.¹⁰⁴ The exemption was ultimately unavailable because the issuer, unknown to the broker-dealer, had made contemporaneous sales to out-of-state residents. The Commission agreed, therefore, that the broker-dealer, International Shareholders, as well as the issuer, had violated section 5, but held that the broker-dealer's violation was not "willful":

Although exemption under Section 3(a)(11) was lost in this case, making respondents' sales of the notes a violation, this was solely caused by the actions of another person, Continental. Respondents were unaware of those actions and had no control over them. Indeed, even had respondent conducted a reasonable investigation into the conduct of Continental, it appears from the record that they could not have discovered that Continental was making sales to out-of-state purchasers because of Continental's elaborate efforts to create an impression of compliance with the exemption In these circumstances, a finding that respondents' violations were "willful" would deprive that term of any significant meaning [I]t follows that respondents' viola-

101. See, e.g., *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965), *aff'g* Sidney Tager, 42 S.E.C. 132 (1964). See also *A.J. White & Co., SEC 1934 Act Release No. 10,645* (Feb. 15, 1974), *aff'd*, *A.J. White & Co. v. SEC*, 556 F.2d 619 (1st Cir. 1977). This administrative definition of "willful" is far less onerous than the "willful" requirement to sustain a criminal conviction. See generally Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 950-58 (1971).

102. SEC 1934 Act Release No. 12,389 (Apr. 29, 1976), [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,493.

103. 15 U.S.C. § 77e (1976).

104. 15 U.S.C. § 77c(a)(11) (1976).

tions cannot be found "willful."¹⁰⁵

Furthermore, after the landmark Supreme Court decision in *Ernst & Ernst v. Hochfelder*,¹⁰⁶ it is doubtful that the courts will sanction application by the Commission of the *Tager* diluted "willfulness" test in any cases embracing fraud charges.¹⁰⁷ More likely, the courts will hold that the Commission must prove scienter, that is, guilty knowledge, or reckless disregard, rather than mere negligence in order to hold a respondent liable for fraud violations in an administrative disciplinary proceeding.¹⁰⁸ If so, proof of "willful" fraud will require either intent to violate the law, or at least actual or constructive knowledge that the law is being violated.¹⁰⁹

2. The Effect of the Proposed Federal Criminal Code

This article does not purport to examine the changes that recent versions of the Proposed Federal Criminal Code would make in *criminal* enforcement of the various federal securities statutes. Nevertheless, securities lawyers should be aware of one significant change in one current version of the Proposed Federal Criminal Code that would substantially affect litigation of SEC administrative disciplinary proceedings. The "Technical and Conforming Amendments" to S. 1437, the Proposed Criminal Code Reform Act of 1978,¹¹⁰ would delete the word "willfully" from most *civil* and *administrative* provisions of the federal securities statutes, including section 15(b)(4) of the 1934 Act.¹¹¹ The reason for this change, urged by the

105. International Shareholders Serv. Corp., SEC 1934 Act Release No. 12,389 (Apr. 29, 1976), [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,493, at 86,285.

106. 425 U.S. 185 (1976). In *Hochfelder*, the Supreme Court held that a plaintiff in a private damage action under the antifraud provisions of rule 10b-5 was required to prove "scienter," which the Court defined as "a mental state embracing intent to deceive, manipulate, or defraud," that is, a "conscious deception." *Id.* at 193-94 n.12.

107. *Tager v. SEC*, 344 F.2d 5 (2d Cir. 1965), was not a fraud case. It involved a violation of the "net capital" rule. See rule 15c3-1 of the 1934 Act, 17 C.F.R. § 240.15c3-1 (1979).

108. For example, the Second Circuit has suggested that proof of scienter is required in an SEC administrative disciplinary proceeding charging fraud. See *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180-81 n.6 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978). In private actions involving fraud, courts require proof of some form of scienter. See, e.g., *McLean v. Alexander*, 599 F.2d 1190, 1197-98 (3d Cir. 1979); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977) (*per curiam*), *cert. denied*, 439 U.S. 830 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

109. Cf. *Ernst & Ernst v. Hochfelder*, 425 U.S. at 194 n.12 (scienter equated with a mental state embracing intent to deceive, but recklessness considered a form of intentional conduct for some purposes). At a minimum, the courts will, in a fraud case, construe the willfulness test of *Tager* to be "more or less congruent with *Hochfelder's* use of scienter." See *Whitney v. SEC*, 604 F.2d 676, 682 n.23 (D.C. Cir. 1979).

110. See, e.g., S. 1437 Proposed Criminal Code Reform Act of 1978, 95th Cong., 2d Sess. § 1761 - Securities Offenses (1978).

111. See 15 U.S.C. § 78o(b)(4) (1976).

SEC, is supposedly to avoid confusion with the culpability standards to be adopted for criminal provisions in the statutes. Thus, the accompanying Senate Report states:

At the suggestion of the Securities and Exchange Commission, the Committee has dropped the culpability standard from the securities laws providing civil sanctions if the culpability standard now provided is "willful." The Committee believes that it is necessary to amend the culpability standard in these provisions in order to avoid the confusion which might result from changing the "willful" standard in the criminal provisions to "knowing" without changing the standards in the civil area to indicate the relationship intended between the level of culpability in the civil and criminal securities laws. However, the definitions of "reckless" and "negligent" in proposed title 18 would have the effect of lowering the standards applicable to civil securities laws since those standards rely on a standard applicable to a "reasonable person" without regard to the fact that a specialist in an area like securities should meet a higher standard.¹¹²

Hopefully, if Congress does enact a new federal criminal code, it will find a better way to harmonize the lesser culpability requirements for civil and administrative provisions with the more stringent ones of the criminal provisions of the federal securities laws without providing for such absolute civil and administrative liability through the abolition of the longstanding "willful" requirement.

C. Public Interest

The Commission may impose a broad range of sanctions — as slight as censure or as severe as revocation of license or bar from the securities industry. The securities statutes, however, require more than simply a finding of a "willful" violation to support the imposition of a sanction. The Commission must also find that the sanction to be imposed is "in the public interest." The "public interest" finding, therefore, is relevant both to whether any sanction at all should be imposed,¹¹³ and if so, the degree of severity the sanction should have in any particular case.

It is difficult to categorize what factors the Commission looks to in making its "public interest" determinations. Professor F. H. Thomforde, Jr., in

112. S. REP. NO. 605, Criminal Code Reform Act of 1977, Part 2, Technical and Conforming Amendments to S.1437, 95th Cong., 1st Sess. 1250-51 (1977).

113. Sometimes, no sanction is imposed even though findings of willful violations are made. See, e.g., *Boettcher & Co.*, 43 S.E.C. 875 (1968); *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

Patterns of Disparity in SEC Administrative Sanctioning Practice,¹¹⁴ provides the following analysis:

The Commission's long experience in attempting to apply general principles, therefore, has yielded a series of more specific factors which guide its choice of sanction. Among the factors relied on by the Commission in determining the public interest are: the nature of the violation [*Richard Bruce & Co.*, 43 S.E.C. 777 (1968)]; the respondent's prior record [*Strathmore Securities, Inc.*, 43 S.E.C. 575 (1967)]; and reputation [*Jay Gershkoff*, SEC 1933 Act Release No. 8505 (Jan. 27, 1969)]; the amount of money involved [*Abbott, Sommers & Co.*, 44 S.E.C. 104 (1969)]; and loss, if any, to investors [*Atlantic Equities Co.*, 43 S.E.C. 354 (1967)]; the number of investors involved [*Thomas Brown, III*, 43 S.E.C. 285 (1967)]; the geographic scope of the violation [*Bateman Eichler, Hill Richards, Inc.*, SEC 1934 Act Release No. 8333 (June 14, 1968)]; the respondent's age [*David G. Baird*, 43 S.E.C. 815 (1968)]; experience [*Stanley K. Shapiro*, SEC 1934 Act Release No. 8552 (Mar. 12, 1969)]; and current status in the business [*Joseph Davis*, SEC 1934 Act Release No. 8541 (Feb. 28, 1969)]; and the respondent's attitude toward the offense including his willingness to reform [*Charles Plohn & Co.*, SEC 1934 Act Release No. 8258 (Feb. 13, 1968)]; and, if loss has been suffered, to make restitution [*Boettcher & Co.*, 43 S.E.C. 875 (1968)].¹¹⁵

Professor Thomforde's listing demonstrates the efficacy of the Commission's "public interest" introductory statement in *Cady, Roberts & Co.*:¹¹⁶ "All the surrounding circumstances and the state of mind of the participants may be taken into consideration in determining what sanctions should appropriately be imposed"¹¹⁷

Appellate courts will scrutinize the sanctions imposed by the SEC to determine whether they serve the public interest in a particular case. When the sanctions are deemed too severe, the court usually will remand the case to the Commission for reconsideration.¹¹⁸ Until relatively recently, however, appellate courts were reluctant to alter the sanction themselves — that is, to bypass the Commission in determining what particular sanction served the public interest in a particular case. Nevertheless, the Second Circuit in *Arthur Lipper Corp. v. SEC*,¹¹⁹ reduced an administra-

114. 42 TENN. L. REV. 465 (1975).

115. *Id.* at 473-74 (footnotes omitted or integrated into text).

116. 40 S.E.C. 907 (1961).

117. *Id.* at 917.

118. *See, e.g.*, *Steadman v. SEC*, 603 F.2d 1126 (5th Cir. 1979); *Beck v. SEC*, 413 F.2d 832 (6th Cir. 1969), *on remand*, 430 F.2d 673 (6th Cir. 1970).

119. 547 F.2d 171 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978).

tive sanction from a permanent bar to a one-year suspension without remanding the case to the SEC.¹²⁰ It remains to be seen, however, whether other reviewing courts will substitute their judgment for that of the specialized agency that supposedly has a peculiar administrative competence for fashioning appropriate sanctions best serving the public interest.¹²¹

One further point respecting "public interest" considerations will be of interest to trial lawyers. It is hornbook law that administrative due process requires that a respondent in an SEC administrative disciplinary proceeding be given adequate notice of the charges against which he must defend. Such notice is ordinarily provided by the order for proceedings, which resembles the complaint in a civil action, or the indictment or information in a criminal prosecution. Thus, the SEC staff ordinarily would not be allowed to introduce at the hearing evidence of alleged violations not recited in the order for proceedings. Nevertheless, over the years the Staff has slipped into a practice of attempting to introduce evidence relating to uncharged violations — not for the purpose of adjudicating those violations constituting the gravamen of the case but rather to support their "public interest" burden as to the appropriateness of imposing a severe sanction for the findings of violations charged in the order.

This practice of adjudicating uncharged violations by clothing them with a "public interest" veil has recently been severely criticized by the Commission in *International Shareholders Services Corp.*¹²² There, in a footnote, the Commission admonished the staff as follows:

Under the heading "Public Interest" the staff asked the administrative judge to find that "It is in the public interest to note that Registrant and Jenkins conducted little, if any, examination of the financial condition and business operation of Continental . . . prior to soliciting customers to purchase their securities . . .

120. The *Lipper* court, in effect, overruled the majority view of the Second Circuit's holding in *Wright v. SEC*, 112 F.2d 89 (2d Cir. 1940), *on remand* 12 S.E.C. 100 (1942), *aff'd*, 134 F.2d 733 (2d Cir. 1943), and instead adopted Judge Swan's dissenting view that a reviewing court had the power to "modify" SEC imposed sanctions. Judge Friendly stated in *Lipper*:

Reviewability of sanctions would seem to be authorized by application of the Administrative Procedure Act . . . the enactment of which adequately explains why *Wright's* suggestion that an agency's discretionary choice of sanctions cannot be altered has not been followed Given our power to review SEC penalty determinations, our authority [*sic*] to limit such sanctions in appropriate cases seems necessarily to follow.

547 F.2d at 183-84.

121. *Cf. Berdahl v. SEC*, 572 F.2d 643, 649 (8th Cir. 1978) (even if reviewing court has the power to modify a Commission sanction, it should not be exercised in the instant case).

122. SEC 1934 Act Release No. 12,389 (April 29, 1976), [1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,493.

and those companies are now in bankruptcy resulting in default on payments to investors" But for the reasons stated in part III of this opinion, respondents' investigation of Continental's finances and Continental's bankruptcy were wholly outside the framework of the order for proceedings. If the staff thought that it had a case in these areas, it should have touched on them in its pleading. Or, having failed to do so the first time around, it should have amended that pleading to raise fraud and quasi-fraud issues. But since the staff did not do that and since the order for proceedings does not even hint at fraud in any sense, the staff's efforts to sneak fraud charges into the proceedings via the back door of "public interest" was grossly improper.¹²³

Despite the *International Shareholders Services* opinion, SEC administrative law judges still permit from time to time the Enforcement Staff to prove the appropriateness of a sanction based upon evidence of statutory violations not charged by the Commission itself in the order for proceedings.¹²⁴

V. THE *HOCHFELDER* SCIENTER STANDARD IN SEC ADMINISTRATIVE DISCIPLINARY PROCEEDINGS

In *SEC v. Capital Gains Research Bureau, Inc.*,¹²⁵ the Supreme Court held that in an SEC civil injunctive action alleging antifraud violations under the Advisers Act, the SEC need not prove scienter nor injury in order to establish a fraud cause of action justifying the imposition of injunctive relief.¹²⁶ At least since *Capital Gains*, in both injunctive actions and administrative disciplinary proceedings, the SEC and its Enforcement

123. *Id.* at 86,288 n.19.

124. *See, e.g.*, Allen & Co., SEC Ad. Pro. File No. 3-5258 (Aug. 2, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,174, at 82,149 (initial decision of SEC ALJ).

125. 375 U.S. 180 (1963).

126. Justice Goldberg framed the issue in the case as follows:

[W]hether Congress, in empowering the courts to enjoin any practice which operated "as a fraud or deceit upon any client or prospective client," intended to require the Commission to establish fraud and deceit "in their technical sense," including intent to injure and actual injury to clients, or whether Congress intended a broad remedial construction of the Act which would encompass nondisclosure of material facts.

375 U.S. at 185-86.

He went on to comment later that:

It would defeat the manifest purpose of the Investment Advisers Act . . . for us to hold . . . that Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit," intended to require proof of intent to injure and actual injury to clients.

Id. at 191-92.

Staff have asserted, in effect, that negligence is fraud under the antifraud provisions of section 17(a) of the 1933 Act¹²⁷ and section 10(b) and rule 10b-5 of the 1934 Act.¹²⁸ However, in *Ernst & Ernst v. Hochfelder*,¹²⁹ the Supreme Court, in a fairly restrictive opinion, held that in an implied private damage cause of action under the antifraud provisions of section 10(b) and rule 10b-5 of the 1934 Act, a plaintiff must prove "scienter" on the part of the defendant. "Scienter" was defined as involving "a mental state embracing intent to deceive, manipulate or defraud."¹³⁰ On its surface the *Hochfelder* opinion left open the question "whether scienter is a necessary element in an action for injunctive relief under section 10(b) and Rule 10b-5."¹³¹ Post-*Hochfelder* decisions¹³² in the federal appellate courts are not in agreement as to whether scienter will be required to be proven by the SEC in a rule 10b-5 injunctive action.¹³³

127. 15 U.S.C. § 77q(a) (1976).

128. 15 U.S.C. § 78j(b) (1976); 17 C.F.R. § 240.106-5 (1979).

129. 425 U.S. 185 (1976).

130. *Id.* at 194 n.12.

131. *See id.*

132. Most post-*Hochfelder* courts have held that the SEC need not prove scienter in civil injunctive actions alleging violations of the antifraud provisions of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976). *See, e.g.*, SEC v. American Realty Trust, 586 F.2d 1001 (4th Cir. 1978); SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, 99 S. Ct. 1432 (1979); SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1978). *But see* Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979). Nor have courts required proof of scienter in connection with violations of the registration provisions of § 5 of the 1933 Act, 15 U.S.C. § 77e (1976). *See, e.g.*, SEC v. Universal Major Indus. Corp., 546 F.2d 1044 (2d Cir. 1976).

For district court decisions after *Hochfelder* requiring the SEC to prove scienter in rule 10b-5 injunctive actions, 17 C.F.R. § 240.10b-5 (1979), *see, e.g.*, SEC v. Randell (Mumford), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,362 (E.D. Va. Feb. 24, 1978), *appeal docketed*, No. 78-1386 (4th Cir. 1978); SEC v. American Realty Trust, 429 F. Supp. 1148, 1171 (E.D. Va. 1977), *rev'd on other grounds*, 586 F.2d 1001 (4th Cir. 1978); SEC v. Wills, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,712 (D.D.C. Dec. 14, 1978); SEC v. Cenco, Inc., 436 F. Supp. 193 (N.D. Ill. 1977); SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976), *aff'd on other grounds*, 565 F.2d 8 (2d Cir. 1977); SEC v. Southwest Coal & Energy Co., 439 F. Supp. 820 (W.D. La. 1977).

The pertinent literature includes: Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U.L. REV. 769 (1976); Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213 (1977); Elsen & Lupert, *Scienter for Injunctions*, 10 REV. SEC. REG. 925 (1977); Harkleroad, *supra* note 3; Lowenfels, *Scienter or Negligence Required for SEC Injunctions Under Section 10(b) and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW. 789 (1978); Maher & Blasi, *Lessons from Ernst & Ernst — Enforcement Proceedings and the Uncommon Law of 10b-5*, 82 DICK. L. REV. 1 (1977); Ruder, *Factors Determining The Degree of Culpability Necessary for Violations of the Federal Securities Laws in Information Transmission Cases*, 32 WASH. & LEE L. REV. 571 (1975); Note, *The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) after Ernst & Ernst v. Hochfelder*, 77 COLUM. L. REV. 419 (1977).

133. Compare SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978) (proof of scienter required in

Courts are just beginning to address the question whether the SEC enforcement staff must prove scienter to establish rule 10b-5 antifraud charges in administrative disciplinary proceedings against broker-dealers pursuant to section 15 of the 1934 Act or similar charges in Advisers Act, 1940 Act, and rule 2(e) proceedings.

In pre-*Hochfelder* cases, the Commission had held that proof of scienter was not required in administrative disciplinary proceedings.¹³⁴ After *Hochfelder*, the SEC General Counsel suggested that the newly articulated rule 10b-5 scienter requirement could be circumvented in rule 2(e) administrative disciplinary proceedings.¹³⁵ However, Judge Friendly, in the *Arthur Lipper* case, assumed without deciding that the *Hochfelder* "scienter" standard *does* apply to SEC administrative disciplinary adjudications:

The [*Hochfelder*] Court said nothing about whether scienter is a necessary element in disciplinary actions under § 15. These actions share with damage suits the quality of visiting serious consequences on past conduct, even though they also have a remedial effect. They thus differ from injunctive proceedings, the objective of which is solely to prevent threatened future harm, although unlawful conduct is necessary — if not always sufficient — to demonstrate the reality of this threat. We therefore assume, *arguendo*, without deciding, that the *Hochfelder* culpability standard applies in disciplinary proceedings.¹³⁶

But this portion of the *Lipper* opinion, persuasive as it indeed may be, is only *dicta*. No appellate court yet has squarely decided this issue.¹³⁷

rule 10b-5 case) with *SEC v. Aaron*, 605 F.2d 612 (2d Cir. 1979), *cert. granted*, No. 79-66, 48 U.S.L.W. 3253 (U.S. Oct. 15, 1979) (proof of scienter not required). Both the defendant and the SEC requested the Supreme Court to grant certiorari in the *Aaron* case. The SEC's brief contains an excellent synopsis of the conflicting district and appellate court decisions on the scienter issue. See Brief for Certiorari of the Securities and Exchange Commission, *Aaron v. SEC*, No. 79-66, 3253 (U.S. Oct. 15, 1979).

134. See, e.g., *Haskins & Sells*, SEC Accounting Series Release No. 73 (Oct. 30, 1952) (rule 2(e) proceeding against accountants).

135. See, e.g., SEC General Counsel Memorandum to SEC Chairman Hills (June 8, 1976), reprinted in SENATE SUBCOMM. ON REPORTS, ACCOUNTING AND MANAGEMENT, app. I, at 1472 n.2 (1976); SEC General Counsel Memorandum to SEC Chairman Hills (Aug. 27, 1976), reprinted in SENATE SUBCOMM. ON REPORTS, ACCOUNTING AND MANAGEMENT, app. I, at 1508 (1976).

136. *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 n.6 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978). In support of his assumption, Judge Friendly cited the following passage from L. JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 267-68 (1965): "Revocation, indeed, seems often to be used as a sanction not so much to control the respondent as to warn others, and thus it has a significant 'penal' component, even though the courts may choose to mask its character by calling it a 'civil' remedy." *Id.*

137. Some appellate courts have skirted the issue. See, e.g., *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588 (10th Cir. 1979); *Wasson v. SEC*, 558 F.2d 879 (8th Cir. 1977). And at

In *Steadman v. SEC*,¹³⁸ however, the United States Court of Appeals for the Fifth Circuit indicated that scienter will be required in SEC administrative disciplinary proceedings charging rule 10b-5 violations.¹³⁹ In *Steadman*, the court squarely held that proof of scienter was required in SEC administrative disciplinary actions charging violations of section 17(a)(1) of the 1933 Act.¹⁴⁰ In so doing, the court referred to the fact that the language in section 17(a)(1)¹⁴¹ is traditional fraud language, almost identical to the language of section 10(b) of the 1934 Act¹⁴² and a portion of rule 10b-5.¹⁴³ The court also noted that both the Supreme Court in *Hochfelder*,¹⁴⁴ a private damage action, and its own court in *SEC v. Blatt*,¹⁴⁵ an SEC civil injunctive action, held proof of scienter to be required in rule 10b-5 actions.

In the *Collins* case,¹⁴⁶ when confronted with the scienter issue in a rule 10b-5 administrative disciplinary proceeding, the court noted its importance but deferred its resolution by remanding the case to the Commission to give the agency the opportunity to express its views. The SEC, to date, has not reconsidered the *Collins* case. In light of the *Collins* remand, the court also remanded a subsequent case, *Nassar & Co., Inc. v. SEC*,¹⁴⁷ to the Commission for reconsideration in light of *Hochfelder*.¹⁴⁸

It is expected that regardless of what the SEC does in its remand opinion in *Collins*, the District of Columbia Circuit and other federal courts of appeals will eventually adopt Judge Friendly's *Arthur Lipper* approach and the approach apparently embraced by the Fifth Circuit in *Steadman* and squarely hold that proof of scienter is required with respect to tradi-

least one appellate court has assumed that the *Hochfelder* scienter standard applies to disciplinary proceedings adjudicated by the National Association of Securities Dealers. See *Buchman v. SEC*, 553 F.2d 816 (2d Cir. 1977).

138. 603 F.2d 1126 (5th Cir. 1979).

139. 17 C.F.R. § 240.10b-5 (1979).

140. 603 F.2d at 1143.

141. 15 U.S.C. § 77q(a)(1) (1976).

142. 15 U.S.C. § 78j(b) (1976).

143. 17 C.F.R. § 240.10b-5 (1979).

144. 425 U.S. 185 (1976).

145. 583 F.2d 1325 (5th Cir. 1978).

146. *Collins Sec. Corp. v. SEC*, 562 F.2d at 826-27.

147. 566 F.2d 790 (D.C. Cir. 1977).

148. Upon remand in *Nasser*, the SEC suggested that the *Hochfelder* scienter standard does not apply to SEC administrative disciplinary proceedings involving rule 10b-5 charges but dodged the issue and held that even if it did apply, scienter had been adequately established. See *Nasser & Co.*, SEC 1934 Act Release No. 15,347 (Nov. 22, 1978), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,904. See also *Steadman Sec. Corp.*, SEC 1934 Act Release No. 13,695 (June 29, 1977), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,243, *rev'd and remanded*, 603 F.2d 1126 (5th Cir. 1979).

tional antifraud charges in SEC administrative disciplinary proceedings. If this occurs, it will be important for litigators to discern what does and does not constitute "scienter" in the context of an administrative disciplinary proceeding.

The *Hochfelder* court defined "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud"¹⁴⁹ and as "knowing or intentional misconduct."¹⁵⁰ However, the *Hochfelder* court left open the question of whether reckless behavior would suffice to meet the scienter test. Since "reckless disregard" has, in criminal mail fraud and securities fraud cases, traditionally been held to constitute constructive knowledge of fraud sufficient to satisfy the scienter or specific intent requirements of these crimes,¹⁵¹ reckless behavior should ultimately be held by the appellate courts to suffice to meet whatever scienter requirements are eventually found applicable in both SEC civil injunctive actions and SEC administrative disciplinary proceedings.¹⁵²

149. *Ernst & Ernst v. Hochfelder*, 425 U.S. at 194 n.12.

150. *Id.* at 197.

151. For example, in *United States v. Benjamin*, 328 F.2d 854 (2d Cir. 1964), Judge Friendly commented:

We think that in the context of § 24 of the Securities Act as applied to § 17(a), the Government can meet its burden by proving that a defendant deliberately closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant. . . . In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or crowbar. Of course, Congress did not mean that any mistake of law or misstatement of fact should subject an attorney or an accountant to criminal liability simply because more skillful practitioners would not have made them. But Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.

Id. at 862-63.

152. See, e.g., *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir.), *cert. denied*, 99 S. Ct. 642 (1978); *Sanders v. John Nuveen & Co., Inc.*, 554 F.2d 790 (7th Cir. 1977); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir. 1977); *Hirsch v. du Pont*, 553 F.2d 750 (2d Cir. 1977). See also *Edwards & Hanly v. Wells Fargo*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,916 (2d Cir. June 27, 1979); *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979); *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir. 1978); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569 (3d Cir. 1977) (*per curiam*), *cert. denied*, 99 S. Ct. 106 (1978); *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719 (W.D. Okla. 1976); *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938); *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

With respect to the so-called remedial fraud charges — § 17(a)(2), (3) of the 1933 Act, 15 U.S.C. § 77g(a)(2), (3) (1976) and § 206(2) of the Advisors Act, 15 U.S.C. § 80b-6(2) (1976) — proof of a negligent violation will probably suffice. See, e.g., *Steadman v. SEC*, 603 F.2d 1126, 1131-34 (5th Cir. 1979).

Judge Leventhal's comments in his concurring opinion in the *Nassar* remand are pertinent in this regard:

Even assuming that a scienter is needed for revocation of registration, that does not mean that what is required is the kind of subjective deceit that *Ernst* [*Hochfelder*] held to be required in an action for damages. As the Commission points out, a broker-dealer may be guilty of intentional misconduct if he deliberately commits certain acts even if he doesn't know they are forbidden by the Act or regulations. In other words, there is no requirement of specific intent that includes a specific element of knowledge of the pertinent rule of law

It may be that the SEC will conclude that scienter for purposes of this kind of discipline must include intentional violation of a duty specifically imposed by a Commission rule or regulation, and also, and perhaps necessarily, include conduct amounting to gross recklessness when the Commission has imposed a duty to make a careful check.¹⁵³

Judge Leventhal seems to invite the Commission to adopt a watered-down scienter test for administrative disciplinary proceedings that may not resemble at all the "guilty knowledge" scienter known to the common law. Whatever definition the courts ultimately adopt for "scienter" in SEC administrative disciplinary proceedings involving traditional fraud charges — whether phrased in terms of guilty knowledge or reckless breach of duty — one would expect that mere negligence will not suffice to constitute scienter and that good faith will always be a defense to traditional fraud charges.¹⁵⁴

153. 566 F.2d at 794-96. The writer is reminded of the comments of SEC Enforcement Chief Stanley Sporkin when he first rationalized the landmark *Hochfelder* decision as follows — "If they want scienter, it's no problem — we'll give them scienter!" If in the eyes of the SEC and its staff, negligence can constitute fraud, then, *a fortiori*, negligence can constitute scienter! As Humpty Dumpty pointed out to Alice "in a rather scornful tone" in Lewis Carroll's, *THROUGH THE LOOKING GLASS* (St. Martins Press, 1977):

"When I use a word . . . it means just what I choose it to mean — neither more nor less The question is . . . which is to be master — that's all."

Id. at 130. See also *Langer Roofing & Sheet Metal, Inc. v. Secretary of Labor*, 524 F.2d 1337, 1339 (7th Cir. 1975).

154. See, e.g., *McLean v. Alexander*, 599 F.2d 1190, 1197-98 (3d Cir. 1979) (*Sunstrand* formulation of recklessness makes it clear, as did *Hochfelder*, that negligence, whether gross, grave or inexcusable, cannot serve as substitute for scienter); cf. *O'Connor v. Ludlam*, 92 F.2d 50, 54 (2d Cir. 1937) (issue is whether defendants had an honest belief that statements made by them were true. If they did have that belief, whether reasonable or unreasonable, they are not liable). See also *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir.), *cert. denied*, 99 S. Ct. 642 (1978); *Hirsch v. du Pont*, 553 F.2d 750 (2d Cir. 1977).

VI. PRACTICE AND PROCEDURE

A. *Discovery or Lack Thereof*

In *Villani v. NYSE*,¹⁵⁵ Judge Lasker characterized the discovery provisions of the Federal Rules of Civil Procedure as "model of procedural due process."¹⁵⁶ Consequently, he initially determined that in stock exchange disciplinary proceedings, the demands of administrative due process required the exchanges to grant respondents pretrial discovery rights. Upon rehearing,¹⁵⁷ Judge Lasker was informed by the New York Stock Exchange that the SEC affords respondents in its administrative disciplinary proceedings virtually no formal pretrial discovery rights. Accordingly, he modified his first *Villani* opinion and did not judicially impose traditional civil discovery concepts upon stock exchange disciplinary proceedings.¹⁵⁸ Judge Lasker's *Villani* opinion was affirmed on other grounds by the United States Court of Appeals for the Second Circuit.¹⁵⁹ It is important to note, however, that *dicta* in the appellate opinion suggests that the court may have ordered the discovery embraced by Judge Lasker's initial decision if the respondent had not in the meantime obtained such discovery.¹⁶⁰

Although the SEC traditionally informs a respondent of the charges against him so that he may attempt to prepare a defense, the Commission has historically maintained that a respondent is not entitled as a matter of right to pretrial discovery of evidence.¹⁶¹ The Administrative Conference of the United States does not agree with the SEC's views in this regard and has for years consistently advocated broadened discovery in SEC adminis-

155. 348 F. Supp. 1185 (S.D.N.Y. 1972).

156. *Id.* at 1192.

157. 367 F. Supp. 1124 (S.D.N.Y. 1973).

158. *Id.* at 1125. Judge Lasker stated:

Were we to write on a clean slate, we might well adhere to our prior ruling since, as a matter of equity, we think a strong argument exists that a person subject to the possibly devastating result of disciplinary action, which may well cause loss of reputation and income, should be entitled to inspect the documents in the hands of his accuser We find considerable merit in the proposition that "Probably no sound reason can be given for failure to extend to administrative adjudication the discovery procedures worked out for judicial proceedings."

Id. (quoting, K. DAVIS, ADMINISTRATIVE LAW TREATISE 589 (1958 ed.)), as quoted in Berger, *Discovery in Administrative Proceedings*, 12 AD. L. BULL. 28, 29 (1959). Judge Lasker also cited Judge Irving R. Kaufman's view that there is an absence of any meaningful discovery procedures in most administrative agencies, a defect that should be corrected. See Kaufman, *Have Administrative Agencies Kept Pace With Modern Court Developed Techniques Against Delay? — A Judge's View*, 12 AD. L. BULL. 103, 114 (1959).

159. See *Sloan v. N.Y.S.E.*, 489 F.2d 1 (2d Cir. 1973).

160. *Id.* at 4.

161. See, e.g., Charles M. Weber, 35 S.E.C. 79 (1953); Michael J. Meehan, 1 S.E.C. 238 (1935).

trative disciplinary proceedings.¹⁶² Unfortunately, such recommendations have mostly been ignored by the Commission and opposed by its enforcement staff. This lack of formal pretrial discovery rights remains one of the low points in the otherwise fair SEC administrative adjudicatory procedures.

As a result of continued criticism from the bar,¹⁶³ and in response to recommendations of the "Wells Committee,"¹⁶⁴ the SEC did amend its Rules of Practice to encourage a modest amount of informal pretrial discovery. Thus, rule 8(d) was amended in 1972 to provide for prehearing conferences

for the purpose of clarifying and simplifying issues and otherwise facilitating or expediting the proceeding [T]he hearing officer . . . *may* in his discretion . . . order a party, including the interested division, to furnish where practicable any or all of the following: an outline of its case or defense; the legal theories upon which it will rely; the identity of the witnesses who will testify on its behalf; and copies of or a list of documents which it intends to introduce at the hearing.¹⁶⁵

The rule is deficient in several respects. First, the granting of discovery is within the discretion of the administrative law judge; a respondent has no absolute right to discovery. Second, a respondent cannot discover prior to trial the investigative transcripts of testimony, memoranda, or statements of interviews of the prospective witnesses the staff will call. Finally, prior to trial, a respondent cannot discover exculpatory material in the hands of the staff that is unlikely to be introduced at trial.¹⁶⁶

162. See, e.g., *Discovery in Agency Adjudication, Recommendations and Reports of the Administrative Conference of the United States*, January 8, 1968 - June 30, 1970, Recommendation No. 21 (1971).

163. See, e.g., Letter from A.F. Mathews to SEC's Advisory Committee on Enforcement Policies and Practices (May 23, 1972), reprinted in MATHEWS, *supra* note 63, at 323, 334-39.

164. See Wells, Cohen & Demmler, *SEC Report of the Advisory Committee on Enforcement Policies and Practices* (June 1, 1972), reprinted in MATHEWS, *supra* note 63, at 239, 244, 287-92.

165. 17 C.F.R. § 201.8(d) (1979) (emphasis supplied).

166. Rule 11.1 of the SEC Rules of Practice, 17 C.F.R. § 201.11.1 (1979), codifies the *Jencks* rule, 18 U.S.C. § 3500 (1976), for the purposes of administrative disciplinary proceedings by providing:

After a witness called by the attorney for the interested Division of the Commission has given direct testimony in a hearing, any other party may request and obtain the production of any statement, or part thereof, of such witness pertaining to his direct testimony, in the possession of the Division, subject, however, to the limitations applicable to the production of witnesses' statements under the Jencks Act, 18 U.S.C. 3500.

The Commission has never adopted the exculpatory evidence production rule of *Brady v. Maryland*, 373 U.S. 83 (1963), and *Giles v. Maryland*, 386 U.S. 66 (1967). Indeed, in virtu-

It is doubtful that the Freedom of Information Act (FOIA)¹⁶⁷ can be used by a respondent to achieve pretrial discovery from the staff not otherwise provided by the Rules of Practice. For example, Merrill Lynch¹⁶⁸ was unsuccessful in its attempt to use the FOIA for discovery purposes in the administrative litigation of the *Scientific Controls*¹⁶⁹ case. Steadman Security Corp.¹⁷⁰ was equally unsuccessful in a 1940 Act disciplinary proceeding against it.¹⁷¹

Investigatory materials generally will be discoverable from the SEC and its staff by any member of the public pursuant to the FOIA *after completion of the SEC's enforcement actions*.¹⁷² However, a respondent in an SEC administrative disciplinary action generally will not be allowed to use the FOIA as a discovery device to obtain intragovernmental documents not otherwise available through traditional administrative discovery procedures.

ally every case that an administrative law judge has sustained the staff's refusal to grant a respondent pretrial discovery, or indeed discovery during trial, of such data as witness lists, exculpatory evidence, transcripts of testimony or witness statements, the Commission has sustained the denial of production, and the courts have generally refused to reverse the Commission's rulings in this regard. However, the Commission and the courts, in ruling on such procedural points, have never espoused the view that denial of discovery is the better course of action; rather, in each case they have merely found that in the particular circumstances, the failure to accord respondents full discovery did not so taint the proceedings as to constitute reversible error. *See, e.g.,* Dlugash v. SEC, 373 F.2d 107 (2d Cir. 1967); Haight & Co., Inc. 44 S.E.C. 481, *aff'd*, No. 71-637 (D.C. Cir. 1971); Jaffee & Co., 44 S.E.C. 285 (1970), *aff'd*, 446 F.2d 381 (2d Cir. 1971); Armstrong, Jones & Co., 43 S.E.C. 888 (1968), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 389 U.S. 958 (1970); Harris Clare & Co., 43 S.E.C. 198 (1966); Hayden Lynch & Co., 43 S.E.C. 25 (1966).

167. 5 U.S.C. § 552 (1976).

168. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC FOIA Release No. 42 (Jan. 26, 1976) (order denying request); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. SEC, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,566 (D.D.C. May 28, 1976) (court denied motion to enjoin SEC evidentiary hearing until disposition of FOIA claim).

169. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC 1934 Act Release No. 14,149 (Nov. 9, 1977), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,365.

170. *See* Steadman Sec. Corp. v. SEC, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,735 (D.D.C. Jan 25, 1973). *See also* Anton v. SEC, No. 75-M-611 (D.Colo. 1975).

171. *See* Steadman Sec. Corp., SEC 1934 Act Release No. 13,695 (June 29, 1977), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,243.

172. *See, e.g.,* Frankel v. SEC, 460 F.2d 813 (2d Cir. 1972); Commercial Envelope Mfg. Co. v. SEC, 450 F.2d 342 (2d Cir. 1971); M.A. Schapiro & Co. v. SEC, 339 F. Supp. 467 (D.D.C. 1972); First Nat'l City Bank, SEC FOIA Release No. 36 (Nov. 4, 1975) (SEC granted public release of Wells Committee submissions as well as investigative transcripts); Jung Ja Malandris, SEC FOIA Release No. 8 (May 29, 1975); Frank J. Abella, Jr., SEC FOIA Release No. 2 (Apr. 24, 1975). *See generally* Frankhauser & Belman, *The Right to Information in the Administrative Process: A Look at the Securities and Exchange Commission*, 18 AD. L. REV. 101 (1966); Peloso, *Discovery of SEC Transcripts*, 10 REV. SEC. REG. 829 (1977).

The principal difference in pretrial procedures between an SEC administrative disciplinary proceeding and a federal court civil action like an SEC civil injunctive action, is that in the administrative proceeding the respondents are virtually barred from taking discovery depositions. The SEC staff can and usually does take *ex parte* investigative depositions of most prospective witnesses, including the respondents, prior to the institution of the administrative proceeding. However, by virtue of rule 15 of the SEC Rules of Practice,¹⁷³ a respondent in an administrative proceeding, can take depositions, not for discovery, but only to preserve the testimony of a witness who will not be able to appear personally at trial. Yet, even for this purpose, the respondent does not have an absolute right to take depositions. It is within the sole discretion of the administrative law judge or the Commission to grant or deny a request for such depositions. In practice, depositions are seldom allowed. Even if a deposition is allowed, it cannot later be introduced into evidence at the hearing unless the proponent establishes, pursuant to rule 15(f), one of the following:

(1) that the witness is dead; (2) that the witness is out of the United States, unless it appears that the absence of the witness was procured by the party offering the deposition; (3) that the witness is unable to attend or testify because of age, sickness, infirmity or imprisonment; (4) that the party offering the deposition has been unable to procure the attendance of the witness by subpoena; or (5) upon application and notice, that such exceptional circumstances exist as to make it desirable, in the interests of justice and with due regard to the importance of presenting the testimony of witnesses orally in open hearing, to allow the deposition to be used.¹⁷⁴

B. Right To Counsel: No Right To Appointed Counsel

Rule 2(b) of the SEC Rules of Practice accords a respondent the right to be represented by counsel of his choice.¹⁷⁵ However, unlike some federal agencies,¹⁷⁶ the SEC takes the position, which has been upheld by appellate courts, that an alleged indigent has no right to be provided appointed counsel by the SEC in administrative disciplinary actions.¹⁷⁷

173. 17 C.F.R. § 201.15 (1979).

174. 17 C.F.R. § 201.15(f) (1979).

175. 17 C.F.R. § 201.2(b) (1979).

176. The Federal Trade Commission, for example, has provided appointed counsel to indigents in its administrative disciplinary proceedings. See *American Chinchilla Corp.*, FTC Docket No. 8774 (Dec. 23, 1969).

177. See, e.g., *Nees v. SEC*, 414 F.2d 211 (9th Cir. 1969); *Boruski v. SEC*, 340 F.2d 991

C. *Multiple Representation: Possible Conflicts of Interest*

Under the SEC rules relating to investigations, the staff has the power to "sequester" an attorney from representing multiple witnesses involved in an SEC investigation.¹⁷⁸ No such comparable sequestration rule is contained in the SEC Rules of Practice that govern litigation of administrative disciplinary proceedings. Nevertheless, counsel must always be aware of the possibility of conflicts of interest stemming from representing multiple clients in a single adjudicatory proceeding.¹⁷⁹

The multiple representation issue arose in the litigation of an administrative disciplinary proceeding against Merrill Lynch, Pierce, Fenner & Smith, Inc. in the *Scientific Controls Corp.* case.¹⁸⁰ The Commission brought the case against Merrill Lynch and forty-nine of its research department employees and salesmen. The SEC's Division of Enforcement formally moved to preclude Merrill Lynch's outside legal counsel from additionally representing most of the firm's employees named as respondents.¹⁸¹ The staff claimed that the close relationship between counsel and the brokerage firm presented actual and potential conflicts of interest to the detriment of the employees-respondents. For example, Merrill Lynch might attempt to defend itself by pointing to the alleged primary culpability of and possible concealment by some of its employees. Alternatively, the employees might try to defend by blaming management.

The SEC administrative law judge refused to preclude the law firm from representing multiple respondents because the enforcement division was

(2d Cir. 1965); Norman Pollisky, 43 S.E.C. 852 (1968); David T. Fleischman, 43 S.E.C. 518 (1967); A.T. Brod & Co., 43 S.E.C. 289 (1967).

178. See Rule 7(b), SEC Rules Regarding Formal Investigative Proceedings, 17 C.F.R. § 203.7(b) (1979).

179. See, e.g., SEC v. Csapo, 533 F.2d 7 (D.C. Cir. 1976); United States v. De Berry, 487 F.2d 448 (2d Cir. 1973); SEC v. Higashi, 359 F.2d 550 (9th Cir. 1966); E.F. Hutton & Co. v. Brown, 305 F. Supp. 371 (S.D. Tex. 1969); United States v. Steel, 238 F. Supp. 575 (S.D.N.Y. 1965), *aff'd*, 359 F.2d 381 (2d Cir. 1966). See generally Mathews, *Effective Defense of SEC Investigations: Laying the Foundation for Successful Disposition of Subsequent Civil, Administrative and Criminal Proceedings*, 24 EMORY L.J. 567, 577-84 (1975); Sonde, *The Responsibility of Professionals Under the Federal Securities Laws: Some Observations*, 68 NW. U.L. REV. 1, 10-11 (1973).

180. See Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC 1934 Act Release No. 10,233 (June 22, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,416 (order for public proceeding).

181. See Summary of Brief of SEC Division of Enforcement, SEC Ad. Pro. File No. 3-4329 (Sept. 26, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,535, at 83,467. Apparently, the law firm had represented most of the respondents when they appeared as witnesses in the underlying investigation. See Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Ad. Pro. File No. 3-4329 (Dec. 6, 1973), [1973-74 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,608, at 83,633.

unable to establish that a conflict *would necessarily occur*. The judge nevertheless conditioned such representation upon fulfillment by the law firm of a procedure designed to elicit the *informed* consent of each respondent. The procedure encompassed the judge's transmittal to each respondent of a copy of his order describing the staff's conflict claims and the law firm's rebuttal, and the granting to each respondent of the opportunity to read the transcript of oral argument on the staff's motion as well as all briefs and other pleadings shedding light upon the problem.¹⁸²

D. Inferences from a Fifth Amendment Plea

Trial counsel should be aware of the dangers arising from a plea by a client in an SEC investigation or administrative disciplinary action of the

182. Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Ad. Pro. File No. 3-4329 (Dec. 6, 1973), [1973-74 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,608. The administrative law judge stated:

The conclusion reached in this order is that if the decisions of the individual respondents to retain Brown Wood as their counsel are *informed* decisions, such representation may be continued. Accordingly, this order is being directed to each individual respondent to assure that he is substantially apprised of the arguments on both sides of the issue, and that his decision with regard to the selection of counsel, whether now re-affirmed or changed, is made with such knowledge. . . . This rather unusual procedure wherein the presiding officer of a tribunal communicates directly with respondents who are represented by counsel is adopted as the most expedient way to obtain informed decisions within a prescribed time limit, and concomitantly to begin to move the case forward. . . . [T]he decision seems to concede that where it is not clear that a conflict of interests will occur between two or more clients of an attorney, the informed consent of the client or clients whose interests more likely would suffer in the event a conflict should develop, can provide justification for the continuation of multiple representation, as here. This is the position reached in this order.

Id. at 83,630.

In a recent civil injunctive case, SEC v. IU Int'l Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,594 (D.D.C. Oct. 24, 1978), Judge Oberdorfer pointed out a possible conflict of interest by corporate defense counsel:

The Court takes note of the possible conflict of interest, pointed to by the SEC and IU's counsel, Morgan, Lewis & Bockius, which may arise if the latter is called upon to testify before the SEC or another body. The circumstances suggest that the Canons of Professional Responsibility will require at least a limited withdrawal. However, a hearing to consider this matter will be scheduled by the order which the Court will enter in the event that the matter has not been earlier resolved voluntarily.

Id. at 94,530 n.2.

In another recent case a federal bankruptcy judge found that the Mudge, Rose law firm had a conflict of interest when it represented simultaneously Westgate-California Corp. and U.S. Nat'l Bank of San Diego in the SEC investigation of financier C. Arnholdt Smith. See *In re Westgate-California Corp. v. Mudge, Rose, Guthrie & Alexander*, Bankruptcy Nos. 74-413, 74-414, 74-1079, 74-1246, 74-2271 (Dec. 29, 1978).

fifth amendment privilege against self-incrimination.¹⁸³

While no adverse inferences can be drawn in a criminal prosecution from a fifth amendment plea or from a failure by the defendant to testify in his own defense,¹⁸⁴ the SEC sometimes draws or seeks to have drawn such adverse inferences in civil and administrative disciplinary proceedings.¹⁸⁵ The rationale for so doing, like the "required records doctrine" exception to a fifth amendment plea,¹⁸⁶ seems to be as follows: when one chooses to do business in a heavily regulated industry and Congress has decided that the public interest requires a federal regulatory agency to have access to information from participants in that industry, then the refusal to provide requested information — whether by way of assertion of a fifth amendment plea or otherwise — provides the basis for drawing an inference that if the information had been provided, it would have been adverse to the person who refused to provide it.

183. U.S. CONST. amend V. See generally Elsen, *Securities Law Investigations*, 2 REV. SEC. REG. 873 (1969); Morrison, *The Fifth Amendment: Disciplinary Sanctions in the Securities Industry Undercut the Constitutional Right to Remain Silent. The Author Suggests an Accommodation*, 3 REV. SEC. REG. 949 (1970).

184. See *Griffin v. California*, 380 U.S. 609 (1965). However, the prosecution may attempt to use a prior fifth amendment plea for cross-examination purposes in a criminal trial if the defendant testifies in his own defense. Compare *United States ex rel. Burt v. New Jersey*, 475 F.2d 234 (3d Cir. 1973), and *United States v. Ramirez*, 441 F.2d 950 (5th Cir. 1971), with *United States v. Anderson*, 498 F.2d 1038 (D.C. Cir. 1974), and *Johnson v. Patterson*, 475 F.2d 1066 (10th Cir. 1973). See generally Comment, *Impeaching a Defendant's Trial Testimony by Proof of Post-Arrest Silence*, 123 U. PA. L. REV. 940 (1975).

185. See, e.g., *SEC v. Stewart*, 476 F.2d 755 (2d Cir. 1973); *Nees v. SEC*, 414 F.2d 211 (9th Cir. 1969); *N. Sims Organ & Co. v. SEC*, 293 F.2d 78 (2d Cir. 1961); *SEC v. Gilbert*, 79 F.R.D. 683 (S.D.N.Y. 1978); Nicholas J. Nickolaou, SEC 1934 Act Release No. 16,210 (Sept. 18, 1979); *Strathmore Securities, Inc.*, 43 S.E.C. 575 (1967), *aff'd*, 407 F.2d 722 (D.C. Cir. 1969); *James De Mamos*, 43 S.E.C. 333 (1967); *J.A. Winston & Co.*, 42 S.E.C. 62 (1964). See generally Kaminsky, *Preventing Unfair Use of the Privilege Against Self-Discrimination in Private Civil Litigation: A Critical Analysis*, 39 BROOKLYN L. REV. 121 (1972); Noonan, *Inferences from the Invocation of the Privilege Against Self-Incrimination*, 41 VA. L. REV. 311 (1955); Ratner, *Consequences of Exercising the Privilege Against Self-Incrimination*, 24 U. CHI. L. REV. 472 (1957); Comment, *The Privilege Against Self-Incrimination in Civil Litigation*, 1968 U. ILL. L.F. 75. See also *Baxter v. Palmigiano*, 425 U.S. 308, 316-20 (1976); *Arthurs v. Stern*, 560 F.2d 477, 478 (1st Cir. 1977).

186. Pursuant to the "required records doctrine," when a business is affected with a public interest and Congress by statute mandates recordkeeping by participants in that business, even *personal* books and records relating to the business must be made available for inspection by regulatory agencies, despite the participant's personal fifth amendment privilege. *Shapiro v. United States*, 335 U.S. 1 (1948). The "required records doctrine" applies to SEC regulated broker-dealers and investment advisers. See *SEC v. Olsen*, 354 F.2d 166 (2d Cir. 1965). See also *United States v. Kaufman*, 429 F.2d 240 (2d Cir. 1970); *United States v. Mahler*, 254 F. Supp. 581 (S.D.N.Y. 1966); *SEC v. Olsen*, 243 F. Supp. 338 (S.D.N.Y. 1965). There is, however, a suggestion in *See v. Seattle*, 387 U.S. 541, 544 (1967), that the Supreme Court may not adhere to the "required records doctrine" as espoused in *Shapiro* the next time it confronts the issue.

In light of recent Supreme Court cases holding that a person cannot be sanctioned civilly or administratively, much less criminally, solely by virtue of asserting his privilege against self-incrimination,¹⁸⁷ it is doubtful whether the Supreme Court would condone the SEC's imposition of a disciplinary sanction against a broker-dealer, investment adviser, or professional such as an attorney or accountant solely by virtue of assertion of the fifth amendment plea.

E. Is There An Applicable Statute of Limitations?

The federal securities statutes contain relatively short statutes of limitations for private damage actions pursued under express causes of action in the statutes.¹⁸⁸ Even with respect to implied private damage causes of action pursuant to rule 10b-5, the courts apply either the comparable state Blue Sky Law statute of limitations or the analogous state common law fraud statute of limitations.¹⁸⁹ Similarly, a five-year statute of limitations governs all criminal prosecutions under the federal securities laws.¹⁹⁰ Nevertheless, the SEC contends that no statute of limitations governs its administrative disciplinary proceedings. For example, in *David G. Baird & Co.*,¹⁹¹ some of the violative conduct had occurred over five years prior to institution of the action by the Commission. In a minute order in that case, the SEC stated in substance that it recognized no statute of limitations in its administrative disciplinary actions. The Commission had previously taken the same position in a minute order in *Thomson & McKinnon*,¹⁹² and subsequently reasserted this view in *Black & Company, Inc.*¹⁹³ This view allows the Commission to litigate from time to time particularly stale or aged charges. For example, in the *Kivitz* case,¹⁹⁴ the charges were four years and eight months stale when the order for pro-

187. See, e.g., *Lefkowitz v. Cunningham*, 431 U.S. 801 (1977); *Lefkowitz v. Turley*, 414 U.S. 70 (1973); *Uniformed Sanitation Men Ass'n v. Commissioner of Sanitation*, 392 U.S. 280 (1968); *Gardner v. Broderick*, 392 U.S. 273 (1968); *Spevack v. Klein*, 385 U.S. 511 (1967); *Garrity v. New Jersey*, 385 U.S. 493 (1967). See also *United States v. Covington*, 395 U.S. 57 (1969); *Leary v. United States*, 395 U.S. 6 (1969); *Haynes v. United States*, 390 U.S. 85 (1968); *In re Buffalo*, 390 U.S. 544 (1968); *Grosso v. United States*, 390 U.S. 62 (1968); *Marchetti v. United States*, 390 U.S. 39 (1968).

188. See, e.g., § 13 of the 1933 Act, 15 U.S.C. § 77m (1976).

189. See, e.g., *Forrestal Village, Inc. v. Graham*, 551 F.2d 411 (D.C. Cir. 1977).

190. 18 U.S.C. § 3282 (1976).

191. 43 S.E.C. 815 (1968).

192. 35 S.E.C. 451 (1952).

193. SEC Ad. Pro. File No. 3-3460 (July 12, 1974), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,921 (opinion of SEC ALJ Markun which contains as Appendix B the unpublished memorandum opinion in *Thomson & McKinnon*).

194. 44 S.E.C. 600 (1971), *rev'd*, 475 F.2d 956 (D.C. Cir. 1973).

ceedings was entered. The alleged violative activity occurred in October, 1964, and the Commission did not commence the rule 2(e) disciplinary proceedings until June 12, 1969. Similarly, in *D.H. Blair & Co.*,¹⁹⁵ many of the charges were several years stale at the time the Commission instituted disciplinary proceedings.

A persuasive argument, however, can be made that the five-year statute of limitations of 28 U.S.C. § 2462 (1976),¹⁹⁶ or a comparable laches rationale should be applied to SEC administrative disciplinary proceedings. Although an SEC administrative law judge rejected this argument in *Black & Company, Inc.*,¹⁹⁷ the case was never appealed to the courts.

If crucial witnesses have died or otherwise become unavailable over a lengthy period of time during which the Commission and its staff have unjustifiably delayed institution of disciplinary proceedings, a compelling case for application of the time bar of laches might arise.¹⁹⁸ At least one federal appellate court has suggested that, in the appropriate circumstances, the equitable doctrine of laches could operate to time bar an SEC administrative disciplinary proceeding.¹⁹⁹

F. *The Quality of the Evidence*

Rule 14(a) of the SEC Rules of Practice relating to "Evidence" states, in part, that the "hearing officer shall receive relevant and material evidence, rule upon offers of proof and exclude all irrelevant, immaterial or unduly repetitious evidence."²⁰⁰ Nothing in the rule requires evidence to be "competent." Indeed, the Commission has traditionally held that it is appropriate in an administrative proceeding to admit any

evidence having some logical relevance even if it has only limited or slight probative value, and even though it might be inadmissible before a jury because too remote or conjectural to be properly evaluated by lay triers of fact . . . and it has been judicially

195. 44 S.E.C. 320 (1970).

196. 28 U.S.C. § 2462 (1976) provides in part:

Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued.

See *H.P. Lambert Co. v. Secretary of Treasury*, 354 F.2d 819 (1st Cir. 1965).

197. SEC Ad. Pro. File No. 3-3460 (June 12, 1974), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,921 (initial opinion of SEC ALJ).

198. Cf. *United States v. Parrott*, 248 F. Supp. 196 (D.D.C. 1965) (indictment for criminal violation of 1933 Act dismissed where prosecution's delay amounted to negligence and defendants were prejudiced by loss of prospective witnesses).

199. See *Russell Irish v. SEC*, 367 F.2d 637 (9th Cir. 1966).

200. 17 C.F.R. § 201.14 (1979).

stressed that a hearing examiner should normally admit all evidence that "can conceivably throw any light upon the controversy."²⁰¹

Since evidentiary rules in an SEC administrative proceeding are not as strict as those in comparable or parallel civil and criminal proceedings in federal district court, defense counsel must be alert to protect against the SEC's use of unreliable evidence.

In reversing a rule 2(e) disciplinary sanction imposed by the SEC against an attorney, the District of Columbia Circuit commented in *Kivitz v. SEC*:²⁰²

[I]t is abundantly clear that such evidence as to Kivitz was hearsay which went far beyond merely permissible circumstantial application [W]e find Kivitz saddled by adverse evidence which never should have been received against him. His alleged complicity was being established from the very testimony, the admissibility of which we reject for it had never been connected up to him. The Supreme Court has pointed out that "men [are not] to be convicted on unsworn testimony of witnesses — a practice which runs counter to the notions of fairness on which our legal system is founded."²⁰³

In reversing a sanction imposed by the SEC in a broker-dealer administrative proceeding in *Klopp v. SEC*,²⁰⁴ the Sixth Circuit pointed out:

Generally, where it is correct to do so, the courts yield to the *expertise* of the members of administrative agencies. However, where the plain issue is whether Klopp or his accusers told the truth, we recognize no special expertise in the Commission The Commission has the right also to draw inferences which we must accept, *if legitimate*. Under Section 25(a) of the Act of 1934 . . . it is provided that "the finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive" Obeying that rule, we cannot conscientiously find that the Commission's decision is supported by substantial evidence when the entire record is reviewed.²⁰⁵

G. Character Witnesses

The *Klopp* and *Kivitz* cases underscore the importance in SEC adminis-

201. Clinton Engines Corp., 41 S.E.C. 408, 411-12 (1963) (footnotes omitted).

202. 475 F.2d 956 (D.C. Cir. 1973), *rev'g* Murray A. Kivitz, 44 S.E.C. 600 (1971).

203. *Id.* at 960.

204. 427 F.2d 455 (6th Cir. 1970), *rev'g* Paine, Webber, Jackson & Curtis (Klopp), 43 S.E.C. 1042 (1969).

205. *Id.* at 460-61 (emphasis in original).

trative disciplinary proceedings of character witness testimony, which the appellate courts found crucial in both cases.²⁰⁶ Since the Commission must tailor its sanction to comply with public interest criteria, character witness testimony can constitute a crucial underpinning of a respondent's trial strategy. In this respect, trial of the administrative proceeding resembles criminal litigation much more than routine civil litigation.²⁰⁷

H. Use of Investigative Transcripts

In preparing to litigate an SEC administrative disciplinary proceeding, it is often difficult to discover prior to trial the nature of the bulk of the evidence the staff will rely upon at trial. However, defense counsel can usually assume that the staff will rely, at least in part, upon extensive investigative transcripts of testimony gathered from witnesses, and perhaps respondents, in the staff's private, *ex parte* investigation that typically precedes institution of the administrative proceeding.²⁰⁸

Admissions contained in these investigative transcripts may be introduced against a respondent.²⁰⁹ The administrative law judge may admit

206. In *Kivitz*, the court noted:

[S]ome seven character witnesses attested to the excellent professional reputation of Kivitz. During his eighteen years at the bar there had never been a complaint about his conduct in any respect. Some might say that the good moral character of an attorney has no special bearing on his life pattern until it becomes a point at issue, but it then may become controlling. . . . [C]ourts have long been cognizant of the significance in human experience of good moral character. Indeed, the Supreme Court has said that under some circumstances "a man's reputation may be sufficient, by itself, to raise a reasonable doubt of his guilt." We think the Sixth Circuit put it just about right in *Klopp v. Securities and Exchange Commission*, 427 F.2d 455, 460 (6th Cir. 1970). There the court noted that an exemplary life "will stand a man in good stead when he is accused of shabby or criminal conduct which he denies, and when he is cast in a contest against accusers whose own lives present nothing special to support assertions of integrity. Character witnesses affirmed Klopp's good life and reputation until he fell afoul of the SEC." So here.

475 F.2d at 960-61 (footnotes omitted).

207. Character witness testimony, for example, was an important part of the defense strategy in other cases such as *Collins Sec. Corp. v. SEC*, 562 F.2d 820 (D.C. Cir. 1977); *Beck v. SEC*, 413 F.2d 832 (6th Cir. 1969), *after remand*, 430 F.2d 673 (6th Cir. 1970); and *AmSwiss Int'l Corp. (Glenn Woo)*, SEC Ad. Pro. File No. 3-4733 (Sept. 8, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,721 (initial opinion of SEC ALJ), *aff'd sub nom.* Glenn Woo, SEC 1934 Act Release No. 13,011 (1976), *aff'd*, 590 F.2d 356 (D.C. Cir.) (per curiam), *cert. denied*, 100 S. Ct. 50 (1979).

208. See Mathews, *supra* note 179, at 589-90.

209. See, e.g., *International Research & Mgt. Corp.*, SEC Advisors Act Release No. 617 (Mar. 6, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,547. Nevertheless, an admission by a corporate agent in an SEC investigative deposition will not be admissible against the corporation in subsequent litigation if the corporation's counsel was not present at the investigative deposition of the agent. See, e.g., *SEC v. Geon Indus., Inc.*, 531 F.2d 39, 43 n.3 (2d Cir. 1976).

into evidence as part of the staff's direct case complete investigative transcripts of witnesses, subject only to the respondent's right to call the witness later for pertinent cross-examination.²¹⁰ Often, investigative transcripts will be used for impeachment or other cross-examination purposes when the respondent takes the stand. Sometimes, when a witness's recollection is exhausted, the commission will receive into evidence prior investigative transcripts containing that witness's testimony.²¹¹ Indeed, pursuant to the *De Sisto* rationale,²¹² admissions in investigative transcripts may be received as affirmative evidence even though a respondent or witness testifies to the contrary at trial.²¹³

VII. DERIVATIVE RESPONSIBILITY: DUTY TO SUPERVISE,
CONTROLLING PERSONS PROVISIONS, AND THE *RESPONDEAT*
SUPERIOR PRINCIPLE

In administrative disciplinary proceedings, the Commission often attempts to hold broker-dealers and their principals liable for statutory violations of their subordinate employees under one or more of the following legal theories: failure to exercise reasonable supervision;²¹⁴ the controlling persons provisions of the 1933 and 1934 Acts;²¹⁵ and the common law doctrine of *respondeat superior*.²¹⁶ These three theories of derivative responsibility provide a vehicle for the Commission to hold one person responsible for the violations of other persons under circumstances in which the Commission is not able to establish secondary liability pursuant to otherwise

210. See *SEC v. Vesco*, 358 F. Supp. 1186, 1188 (S.D.N.Y. 1973) (transcripts may be introduced in connection with SEC motion for preliminary injunction). See also *Strathmore Sec., Inc.*, 43 S.E.C. 575 (1967), *aff'd*, 407 F.2d 722 (D.C. Cir. 1969) (use by the SEC of respondents own books and records).

211. See, e.g., *Robert A. Podesta*, SEC 1934 Act Release No. 16,209 (Sept. 18, 1979).

212. *United States v. De Sisto*, 329 F.2d 929 (2d Cir.), *cert. denied*, 377 U.S. 979 (1964).

213. See, e.g., *Allesandrini & Co.*, SEC 1934 Act Release No. 10,466 (Oct. 31, 1973).

214. See § 15(b)(4)(E) of the 1934 Act, 15 U.S.C. § 78o(b)(4)(E) (1976). See also *Paine, Webber, Jackson & Curtis*, 43 S.E.C. 1042 (1969); *Shearson, Hammill & Co.*, 42 S.E.C. 811 (1965); *Reynolds & Co.*, 39 S.E.C. 902 (1960).

215. See § 15 of the 1933 Act, 15 U.S.C. § 77o (1976); § 20(a) of the 1934 Act, 15 U.S.C. § 78t(a) (1976). See also *Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973).

216. See, e.g., *SEC v. Geon Indus., Inc.*, 531 F.2d 39 (2d Cir. 1976); *SEC v. Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359 (6th Cir. 1970), *aff'g* *Armstrong, Jones & Co.*, 43 S.E.C. 888 (1968); *Black & Co., Inc. (R.W. Pressprich & Co.)*, SEC Ad. Pro. File No. 3-3460 (July 12, 1974), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,921 (initial opinion of SEC ALJ).

applicable conspiracy²¹⁷ or aiding and abetting²¹⁸ principles.²¹⁹

The "duty to supervise" theory stems primarily from section 15(b)(4)(E) of the 1934 Act,²²⁰ which permits sanctions where a broker-dealer "has failed to reasonably supervise" a subordinate employee who commits a violation.²²¹ The "controlling persons" theory is also statutorily

217. See 18 U.S.C. § 371 (1976). The criminal conspiracy doctrine applies as well to civil and administrative securities cases. See, e.g., SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189 (N.D. Tex. 1970), *aff'd*, 448 F.2d 652 (5th Cir. 1971); Petit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963); H.L. Greene Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955).

218. See 18 U.S.C. § 2 (1976). Since the 1964 Securities Act Amendments, 78 Stat. 565 (1964), pertinent subsections of § 15(b) of the 1934 Act, 15 U.S.C. § 78o (1976), specifically contain "aiding and abetting" language. Moreover, the criminal aiding and abetting doctrine applies as well to civil and administrative securities cases. See RESTATEMENT OF TORTS § 876 (1939). See generally SEC v. Coffey, 493 F.2d 1034, 1316 (6th Cir.), *cert. denied*, 420 U.S. 908 (1974); Stead v. SEC, 444 F.2d 713, 716 (10th Cir.), *cert. denied*, 404 U.S. 1059 (1971); SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189 (N.D. Tex. 1970), *aff'd*, 448 F.2d 652 (5th Cir. 1971); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir.), *cert. denied*, 347 U.S. 989 (1969); SEC v. J.P. Howell & Co., Inc., 229 F. Supp. 699 (D.N.J. 1962), *aff'd*, 330 F.2d 958 (3d Cir. 1964); SEC v. Scott Taylor & Co., 183 F. Supp. 904 (S.D.N.Y. 1959); Sutro Bros. & Co., 41 S.E.C. 443 (1963); Burley & Co., 23 S.E.C. 461 (1946). See also Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 44 (2d Cir.), *modified*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,525 (2d Cir. May 22, 1978), *cert. denied*, 99 S. Ct. 642 (1978); Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977); Hirsch v. du Pont, 553 F.2d 750, 759 (2d Cir. 1977); Woodward v. Metro Bank of Dallas, 522 F.2d 85, 97 (5th Cir. 1975); Landy v. FDIC, 486 F.2d 139, 162-63 (3d Cir.), *cert. denied*, 416 U.S. 960 (1973).

219. See Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972). See generally Ruder, *Aiding and Abetting*, 7 REV. SEC. REG. 882 (1974). See also Markham & Meltzer, *Secondary Liability Under the Commodity Exchange Act — Respondeat Superior, Aiding and Abetting, Supervision, and Scienter*, 27 EMORY L.J. 1115 (1978).

220. Section 15(b)(4)(E) of the 1934 Act states in pertinent part:

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds [such sanction] is in the public interest and that such broker or dealer . . .

(E) . . . has failed reasonably to supervise, with a view to preventing violations . . . , another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if — (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

15 U.S.C. § 78o(b)(4)(E) (1976).

221. The statutory duty to supervise was first added to the 1934 Act as then § 15(b)(5)(E) in the 1964 Securities Act Amendments, 78 Stat. 565 (1964). The provision became the currently effective § 15(b)(4)(E) in the 1975 Securities Acts Amendments, 89 Stat. 79 (1975). Prior to 1964, the SEC had developed a case law "duty to supervise" principle through ad

based.²²² Section 15 of the 1933 Act²²³ provides that anyone controlling a person liable under section 11²²⁴ or 12²²⁵ shall also be liable "unless the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which liability of the controlled person is alleged to exist."²²⁶ Section 20(a) of the 1934 Act²²⁷ creates similar controlling person liability but contains a slightly different defense. It provides that the controlling person will be liable "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation"²²⁸

Respondeat superior, on the other hand, is a common law agency doctrine that triggers liability without fault.²²⁹ It holds a principal strictly liable for the acts of an agent under certain enumerated conditions.²³⁰

Unlike the "duty to supervise," or the "controlling persons" provisions, a good faith effort to comply with the law is not a defense to the imposition of *respondeat superior* liability upon an otherwise innocent principal for the statutory violations of an agent or employee. Because of this severe liability-without-fault aspect of *respondeat superior*, an important issue arises in litigation against broker-dealers: if a broker-dealer employer or

hoc administrative adjudication. See, e.g., *Reynolds & Co.*, 39 S.E.C. 902, 917 (1960); *R.H. Johnson & Co.*, 36 S.E.C. 467 (1955), *aff'd*, 231 F.2d 523 (D.C. Cir. 1956); *Merrill Lynch, Pierce, Fenner & Beane*, 31 S.E.C. 494 (1950).

222. See Gottesman, *Brokers' Derivative Liability: Does Supervision Make A Difference?*, 41 BROOKLYN L. REV. 181 (1974); Note, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U.L. REV. 1019 (1973); Comment, *Secondary Liability of Controlling Persons Under the Securities Acts: Toward an Improved Analysis*, 126 U. PA. L. REV. 1345 (1978). See also Annot., 38 A.L.R. Fed. 725 (1978); Annot., 32 A.L.R. Fed. 714 (1977).

223. 15 U.S.C. § 77o (1976).

224. 15 U.S.C. § 77k (1976).

225. 15 U.S.C. § 77l (1976).

226. 15 U.S.C. § 77o (1976).

227. 15 U.S.C. § 77t(a) (1976).

228. *Id.*

229. See *New York Cent. R.R. v. White*, 243 U.S. 188 (1917). See generally Annot., 32 A.L.R. Fed. 714 (1977).

230. Section 219 of RESTATEMENT (SECOND) OF AGENCY (1958) sets forth the following doctrine of *respondeat superior*:

(1) A master is subject to liability for the torts of his servants committed while acting in the scope of their employment.

(2) A master is not subject to liability for the torts of his servants acting outside the scope of their employment, unless:

(a) the master intended the conduct or the consequences, or

(b) the master was negligent or reckless, or

(c) the conduct violated a nondelegable duty of the master, or

(d) the servant purported to act or to speak on behalf of the principal and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation.

See also RESTATEMENT (SECOND) OF AGENCY §§ 261-262 (1958).

principal can establish reasonable supervision and good faith, thereby avoiding "failure to supervise" and "controlling person" liability, will there nevertheless be *respondeat superior* liability as a result of statutory violations committed by an agent or employee? The existing case law is confused. The answer may depend upon both the court of appeals that reviews the case and whether the cause of action is pursued in the context of a private damage action, an SEC civil injunctive action, or an SEC administrative disciplinary proceeding.

The Courts of Appeals for the Fourth, Fifth, Sixth, and Seventh Circuits apply the strict liability principle of *respondeat superior* in private damage actions involving broker-dealers.²³¹ In contrast, the Courts of Appeals for the Third, Eighth, and Ninth Circuits hold that the controlling persons provisions of the 1933 and 1934 Acts preclude *respondeat superior* liability in private damage actions.²³² The law in the Second Circuit in this respect is unsettled,²³³ and the Courts of Appeals for the First, Tenth, and District of Columbia Circuits have yet to develop this area.²³⁴

Dissenting from a denial of certiorari in *Sennott v. Rodman & Renshaw*,²³⁵ Justice Douglas, with the concurrence of Justice Blackmun, ap-

231. See, e.g., *Holloway v. Howerdd*, 536 F.2d 690 (6th Cir. 1976); *Carras v. Burns*, 516 F.2d 251 (4th Cir. 1975); *Fey v. Walston & Co., Inc.*, 493 F.2d 1036 (7th Cir. 1974); *Lewis v. Walston & Co., Inc.*, 487 F.2d 617 (5th Cir. 1973); *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part, rev'd in part, and remanded*, 422 F.2d 1124 (4th Cir. 1970).

232. See, e.g., *Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665 (9th Cir. 1978); *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761 (3d Cir. 1976); *Rochez Bros. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975); *Zweig v. Hearst Corp.*, 521 F.2d 1129 (9th Cir. 1975); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967). See also *Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F.2d 689 (9th Cir. 1967), *cert. granted*, 390 U.S. 942, *cert. dismissed after settlement*, 393 U.S. 801 (1968). In its *amicus* brief the SEC argued that the controlling persons provisions of the 1933 and 1934 Acts did not preclude *respondeat superior* liability in an employer-employee situation. The SEC further argued that traditional agency principles placed liability upon the principal if the agent possessed actual, apparent, or ostensible authority or otherwise acted within its agency powers. Brief of SEC as *Amicus Curiae*, *Kamen & Co. v. Paul H. Aschkar & Co.*, 390 U.S. 942 (1968).

233. In *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 49 n.19 (2d Cir. 1978), *modified*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,525, *cert. denied*, 99 S. Ct. 642 (1978), the Second Circuit sidestepped "the rather thorny controlling person — *respondeat superior* issue." But see *Gordon v. Burr*, 506 F.2d 1080 (2d Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc).

234. Some of the circuits have applied *respondeat superior* or other general agency principles in cases arising under the Commodity Exchange Act, 7 U.S.C. §§ 1-22 (1976). See, e.g., *Master Commodities, Inc. v. Texas Cattle Mgt. Co.*, 586 F.2d 1352 (10th Cir. 1978). However, commodities cases are neither persuasive nor conclusive precedent for securities cases. Unlike the 1933 and 1934 Acts, § 2(a)(1) of the Commodity Exchange Act, 7 U.S.C. § 4 (1976), contains an express *respondeat superior* liability provision. See *Markham & Meltzer*, *supra* note 219, at 1125.

235. 474 F.2d 32 (7th Cir. 1972), *cert. denied*, 414 U.S. 926 (1973).

peared to approve of the application of *respondeat superior* and similar agency principles, as well as section 20(a) controlling persons principles, to broker-dealers in private damage actions:

Rodman's liability for the acts of its partner, William Rothbart, are [*sic*] indisputable under § 20(a), as they are [*sic*] under general principles of agency. But liability cannot be confined to those formally authorized to act in the firm's behalf, for such a rule would constrict the common-law principles of apparent authority, a construction inconsistent with the broad remedial purpose of the legislation. The purpose of the Act is to expand, not restrict, the public's remedies.

. . . Rodman must be responsible for Jordan's acts even under general agency principles — which do not require even that the principal benefit from the apparent agent's fraud. Restatement (Second) of Agency §§ 261-262. Agency principles have been applied to find liability on facts almost identical to those here

. . . .²³⁶

Nevertheless, by denying certiorari in the case, the Supreme Court has left confused "the rather thorny controlling person — *respondeat superior* issue" in private damage actions against broker-dealers.²³⁷

Although inadequately rationalized in the applicable opinions, judicial treatment of duty to supervise, controlling persons liability, and *respondeat superior* in SEC civil injunctive actions has differed somewhat from such consideration in private damage actions. For example, in *SEC v. Lum's, Inc. (Lehman Bros.)*,²³⁸ the district court refused to impose rule 10b-5 liability in an "inside" information case on the broker-dealer defendant on a *respondeat superior* rationale in circumstances where the broker-dealer was able to prove adequate supervision under section 15(b)(5)(E) of the 1934 Act and therefore good faith.²³⁹

In *Lum's*, the SEC contended that in its civil injunctive actions seeking remedial, prophylactic relief, *respondeat superior* liability was appropriate and neither proof of adequate supervision under section 15(b)(5)(E) nor good faith under the controlling persons provisions of section 20(a) of the 1934 Act should preclude holding the broker-dealer (employer-principal) liable for the violative acts of its employee-agent. The court held, however, that imposition of liability without fault against broker-dealers was

236. 414 U.S. at 929-30 (Douglas, J., dissenting from denial of certiorari) (footnotes and citations omitted).

237. See *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 48 n.19 (2d Cir.), *modified*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,525, *cert. denied*, 99 S. Ct. 642 (1978).

238. 365 F. Supp. 1046 (S.D.N.Y. 1973).

239. *Id.* at 1064-65.

not appropriate.²⁴⁰ Judge Tyler commented:

To hold Lehman liable on a theory of *respondeat superior* would . . . do violence to the legislative intent underlying the [1934] Act Insistence upon a standard of *respondeat superior* would result in the imposition of absolute liability upon broker-dealers in this context. Even in [SEC] enforcement proceedings I believe there should be at least negligent conduct required before the imposition of liability. The jurisdiction of the SEC under § 10(b) is not without limits.²⁴¹

Thus, *Lum's* appears to support the following propositions: *respondeat superior* will not be applied against broker-dealers in SEC injunctive enforcement proceedings; the controlling persons provisions of section 15 of the 1933 Act and section 20(a) of the 1934 Act will be applied, but "good faith" will be a defense; and lack of knowledge of or participation in the employee's violation *and* proof of adequate supervision under current section 15(b)(4)(E) will constitute the type of proof of "good faith" that will preclude liability for violative conduct of employees and agents.²⁴²

Some commentators contend that the United States Court of Appeals for the Second Circuit, in *SEC v. Management Dynamics, Inc.*,²⁴³ implic-

240. *Id.* at 1062. It is interesting to note that broker-dealers fare better in this respect than corporate issuers. Thus, Judge Tyler did hold the principal defendant, *Lum's Inc.*, a corporate issuer, liable for the acts of certain of its agents, officers, and employees, on traditional agency principles:

In general, courts have held a corporation-issuer liable on agency principles for what can be deemed the corporate acts of its principal agents without much discussion, and it seems to me that this is the appropriate analysis — if only because it is difficult to conceive of a corporation acting in any other way than by its managing officers and directors. On this basis I conclude that *Lum's* is . . . liable for the violations of § 10(b) and Rule 10b-5.

Id. at 1061.

241. *Id.* at 1063-64. Judge Tyler further commented:

The primary duty owed by a broker-dealer to the public is to supervise its employees in an adequate and reasonable fashion. . . . But to recognize more stringent standards for the exercise of control by a broker-dealer over its salesmen does not require the imposition of absolute liability upon the former for every violation of the latter. In fact, it would seem that the regulatory goals of the Commission could at least be substantially achieved by the enforcement of this duty, rather than by the attempt to read a nonexistent insurer's liability into the statute for broker-dealers. Every violation of Rule 10b-5 by a salesman does not necessarily imply a breach of the employer's duty to supervise.

Id. at 1064.

242. *Cf.* *SEC v. Sorg Printing Co.*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,034 (S.D.N.Y. Mar. 28, 1975) (employer not secondarily liable on theory of *respondeat superior* when not charged with knowledge or when employees were not acting within scope of employment).

243. 515 F.2d 801 (2d Cir. 1975).

itly rejected the *Lum's* rationale that section 20(a) precludes relief against broker-dealers under the doctrine of *respondeat superior* in SEC civil injunctive actions.²⁴⁴ This view is probably incorrect. In *Management Dynamics*, the court did hold a broker-dealer firm (A.J. Carno, Inc.) liable for the violations of its vice-president in charge of trading (Nadino) under general agency principles. The court held that the controlling persons provision of section 20(a) expanded rather than restricted the scope of liability under the 1934 Act and that it was not intended to be the "sole measure" of employer liability.²⁴⁵ However, the court did not address the *Lum's* opinion. Additionally, while applying general agency principles, the court did not purport to adopt necessarily a concept of strict *respondeat superior* liability for broker-dealers in SEC enforcement proceedings.²⁴⁶

Actually, *Lum's* and *Management Dynamics* can be reconciled. In *Lum's*, the corporate issuer was held liable for the acts of its chief executive officer (Chasen) since corporations can only act through their managing officers and directors. There was no suggestion in *Lum's*, however, that the corporation would have been held liable on a *respondeat superior* rationale for the acts of every corporate employee. In *Management Dynamics*, A.J. Carno, Inc., the broker-dealer firm, was also a corporation, and Nadino was a high level executive officer. Holding the broker-dealer corporation liable on an agency theory for the corporate acts of its high-level executives is a far cry from holding the broker-dealer liable on a

244. See, e.g., Markman & Meltzer, *supra* note 219, at 1124.

245. 515 F.2d at 812. The court noted, however, that "liability in the employment context is a vastly different situation from the liability of individual outside directors, which is properly measured only under the 'controlling person' provision. See *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc)." *Id.* at 813 n.8.

246. The court commented:

We need not decide today whether the entire corpus of agency law is to be imported into the securities acts for all purposes. We hold only that, in the circumstances of this case, the SEC in this enforcement action was entitled to an injunction against Carno because of Nadino's trading activity. As vice president in charge of trading, Nadino occupied a prominent position within the company. By virtue of his position he was able for months to submit fictitious quotations on MD stock in the firm's name in the pink sheets. The misleading appearance of activity in MD stock thereby created was in significant measure a consequence of the employment relationship, which not only afforded Nadino the opportunity to submit the misleading quotations, but identified the firm as their source. The apparent authority exercised by Nadino makes it appropriate to enjoin Carno from violation of the anti-fraud provisions. *We stress again, however, that we intimate no view as to other cases which may involve lesser employees, actions for damages, other agency principles, or respondeat superior, which may be broader than the apparent authority involved here.* Such cases may involve entirely different policy considerations that are best consigned to future resolution.

Id. at 813 (footnotes omitted, emphasis supplied).

respondeat superior basis for the acts of all its employees including all of its salesmen.

A subsequent Second Circuit decision, *SEC v. Geon Industries, Inc.*,²⁴⁷ demonstrates that the *Lum's* rationale was not abrogated by *Management Dynamics*. In *Geon*, the court refused to enter an SEC-requested injunction against a broker-dealer (Edwards & Hanly) on a *respondeat superior* theory for violations by one of the firm's employees (Rauch) who was a registered representative in a branch office. The *Geon* court acknowledged that the *Lum's* decision was wrong to the extent that it implied a broker-dealer could be liable for its employee's acts *only* as a controlling person under section 20(a).²⁴⁸ This is so because a broker-dealer can also be liable for failing to supervise, and failing to supervise is not necessarily a lack of good faith triggering section 20(a) controlling person liability.²⁴⁹ However, in *Geon*, the court specifically found that Edwards & Hanly had adequately supervised its employees, and refused to apply the liability-without-fault *respondeat superior* rule advocated by the SEC.²⁵⁰

While denying injunctive relief on a *respondeat superior* basis in the civil injunctive action, the court in *Geon* did acknowledge, without purporting to either adopt or reject the rule of some circuits that *respondeat superior* liability will be imposed against broker-dealers in private actions for rescission or damages.²⁵¹ The *Geon* court also noted, without accepting or rejecting, the SEC practice in its administrative disciplinary proceedings of disciplining broker-dealers for the willful acts of employees on a *respon-*

247. 531 F.2d 39 (2d Cir. 1976).

248. *Id.* at 54.

249. *Id.* See also *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 811-13 (2d Cir. 1975).

250. 531 F.2d at 54. The court commented:

Management Dynamics, according to the Commission, points in the direction of imposing liability on E & H on the basis of the principle of *respondeat superior* even though E & H did not fail reasonably to supervise. That argument, however, is based on a significant extension of *Management Dynamics*, an extension which, at least in this context, we decline to make. . . . To say that an injunction must issue against a brokerage firm whenever one could have been issued against a registered representative significantly overreads *Management Dynamics*. As the carefully qualified approach of the case makes clear, the fact that use of common law agency concepts may be appropriate in some circumstances does not mean that we should import them where this will not further the policies of the securities acts.

Id.

251. The court stated:

It is true that courts have used agency principles to impose liability for rescission or damages on brokerage firms, in suits brought by persons in privity, in circumstances similar to those here present. *Lewis v. Walston & Co.*, 487 F.2d 617, 623-24 (5th Cir. 1973) (sale of unregistered stock, within scope of employment); *Fey v. Walston & Co.*, 493 F.2d 1036, 1051-53 (7th Cir. 1974) (churning). See also *Johns*

deat superior rationale, even in the absence of a finding of inadequate supervision.²⁵²

The United States Court of Appeals for the Seventh Circuit, in *SEC v. First Securities Co.*,²⁵³ held a broker-dealer liable for the violations of its president on four separate theories, three of them rooted in the 1934 Act. The case had originated as an SEC civil injunctive enforcement action, but the issue for decision involved a claim for money damages by a customer after the firm had been placed into an equity receivership as a result of the SEC injunctive action.²⁵⁴

The court first applied the traditional agency principle that a principal is liable for the acts of its agent committed with apparent authority.²⁵⁵ Relying upon *Blackburn v. Witter*,²⁵⁶ the court then found that the personal acts of the agent were nevertheless within the scope of his agency relationship on behalf of his employer.²⁵⁷ This finding was, in essence, an application of *respondeat superior*. Second, relying upon *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*,²⁵⁸ the court found that the firm had controlling person liability under section 20(a) of the 1934 Act²⁵⁹ for the violations committed by its president.²⁶⁰ Third, the court held the firm liable as

Hopkins University v. Hutton, 422 F.2d 1124, 1130 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974) (fraudulent misrepresentations).

Id. at 54-55.

252. *Id.* at 55 n.21. There is an important evidentiary point in *Geon* that is useful to defense counsel in "supervision" cases. The court held that implementation of stricter supervisory procedures at a later point in time cannot be used as evidence that prior procedures were deficient. *Id.* at 52. *See also* *Smyth v. Upjohn Co.*, 529 F.2d 803 (2d Cir. 1975); *FED. R. EVID.* 407.

253. 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

254. The president of First Securities had murdered his wife and committed suicide, leaving a suicide note revealing that the firm was bankrupt because of his thefts that had been concealed by spurious escrow accounts. *Id.* at 983.

255. *Id.* at 985. The court cited RESTATEMENT (SECOND) OF AGENCY §§ 261-262 (1958).

256. 201 Cal. App. 2d 518, 19 Cal. Rptr. 842 (1962).

257. 463 F.2d at 986.

258. 85 F. Supp. 104, 122-23 (W.D. Ark. 1949).

259. 15 U.S.C. § 78t(a) (1976).

260. In refuting the good faith defense of § 20(a), the court pointed out:

"[T]o satisfy the requirement of good faith . . . it is necessary for the [controlling person] to show that some precautionary measures were taken to prevent the injury suffered," *Lorenz v. Watson*, 258 F. Supp. 724, 732 (E.D. Pa. 1966), and "that failure of the controlling person to maintain and diligently enforce a proper system of internal supervision and control constitutes participation in the misconduct and the violation will be deemed to have been committed not only by the controlled person, but also by the controlling person who did not perform the duty to prevent it." *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 438 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

463 F.2d at 987.

an aider and abettor of its president's violations.²⁶¹ Fourth, the court held the firm liable for failing to comply with rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc.,²⁶² relating to supervisory procedures and recordkeeping.²⁶³

The United States Court of Appeals for the Sixth Circuit, in *SEC v. Coffey*,²⁶⁴ albeit a case not involving a broker-dealer defendant, has taken a rather extreme position respecting the controlling persons provision of section 20(a). In *Coffey*, the court was faced with the question of whether the chief executive officer (King) of an issuer-corporation (King Resources) was liable for the violations of a financial vice-president (Coffey). Without addressing *respondeat superior* specifically or agency principles generally, the *Coffey* court held squarely that "section 20(a) of the 1934 Act may not be relied upon by the SEC in an injunctive enforcement action."²⁶⁵ The court reached this outright proscription by analyzing the provisions of both section 20(a) and section 20(b) of the 1934 Act²⁶⁶ and determining that the SEC was not a "person" within the meaning of section 20(a).²⁶⁷ The SEC, therefore, could only proceed on a controlling persons theory pursuant to section 20(b).²⁶⁸

The *Coffey* court did not address whether the corporate entity itself, as opposed to its chief executive officer, could have been liable on a *respon-*

261. *Id.* Among other cases, the court relied upon *Buttery v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969), and *Brennan v. Midwestern Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969).

262. 463 F.2d at 988.

263. *See, e.g.*, *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969). *See generally* Wolfson & Russo, *The Stock Exchange Member: Liability for Violations of Stock Exchange Rules*, 58 CALIF. L. REV. 1120 (1970). *See also* authorities cited in Markham & Meltzer, *supra* note 219, at 1156-57 n.214.

264. 493 F.2d 1304 (6th Cir. 1974).

265. *Id.* at 1318.

266. 15 U.S.C. § 78t(a), (b) (1976).

267. The court stated:

Section 20(b) of the 1934 Act provides for the *unlawful* actions of controlling persons, and the SEC may only seek injunctions against unlawful actions. . . . Section 20(a) of the 1934 Act makes a controlling person liable "to any person to whom such controlled person is liable." As a matter of legislative interpretation, we hold that the SEC is not a person under section 20(a), since section 20(a) was meant to specify the liability of controlling persons to private persons suing to vindicate their interests. Section 20(b) sets forth the standard of lawfulness to which a controlling person must conform, on penalty of liability in injunction to the SEC or criminal prosecution.

493 F.2d at 1318.

268. *Id.* The court noted that:

Under section 20(b), there must be shown to have been knowing use of a controlled person by a controlling person before a controlling person comes within its ambit. Without such a restriction, every link in a chain of command would be personally

deat superior rationale. It did note in a passing footnote, however, that secondary liability is sometimes "imposed upon corporations whose agents commit violations, under the traditional concept of *respondeat superior*."²⁶⁹

In *SEC v. Savoy Industries*,²⁷⁰ a case not involving a broker-dealer defendant,²⁷¹ the United States Court of Appeals for the District of Columbia Circuit acknowledged the inconsistencies in the *Lum's*, *Management Dynamics*, and *Coffey* cases.²⁷² Although the court appeared to be willing to recognize section 20(a) controlling persons liability in a SEC injunctive action, it could not properly address the issue due to insufficient development of the record by the lower court.²⁷³

The Courts of Appeals for the First, Third, Fourth, Fifth, Eighth, Ninth, or Tenth Circuits have not dealt squarely with the application of *respondeat superior* or controlling persons liability of broker-dealer firms in SEC civil injunctive actions.²⁷⁴

However, application of these theories of secondary or derivative liability in SEC administrative disciplinary proceedings against broker-dealer firms has been long promoted by the SEC and accepted by some courts.²⁷⁵ The Commission has consistently held that good faith or reasonable supervision is not necessarily a defense in a broker-dealer administrative disciplinary proceeding and that a broker-dealer does have both controlling

criminally and civilly liable for the violations of inferior corporate agents. This was not the congressional intent in enacting section 20(b).

Id.

269. *Id.* at 1316 n.27. In support, however, the court cited a *private damage action*, *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part, rev'd in part, and remanded*, 422 F.2d 1124 (4th Cir. 1970).

270. 587 F.2d 1149 (D.C. Cir. 1978).

271. The *Savoy* case concerned the liability of an individual (Zimmerman) and did not involve asserted *respondeat superior* liability of a broker-dealer firm or a corporate issuer. See 587 F.2d at 1161-62.

272. *Id.* at 1169-70.

273. *Id.* at 1170.

274. At least one additional district court has applied *respondeat superior* liability to a broker-dealer in an SEC injunctive action. See *SEC v. Charles A. Morris & Assocs.*, 386 F. Supp. 1327, 1335 (W.D. Tenn. 1973); cf. *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 458 F. Supp. 1110 (S.D.N.Y. 1978), *aff'd*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,916 (2d Cir. June 27, 1979); *Plunkett v. Dominick & Dominick, Inc.*, 414 F. Supp. 885 (D. Conn. 1976) (application of *respondeat superior* in private damage action). See also *SEC v. Sorg Printing Co.*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,034 (S.D.N.Y. Mar. 28, 1975).

275. See, e.g., *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 362 (6th Cir.), *cert. denied*, 389 U.S. 958 (1970); *Black & Co., Inc. (R.W. Pressprich & Co.)*, SEC Ad. Pro. File No. 3-3460 (July 12, 1974), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,921 (opinion of SEC ALJ).

person and *respondeat superior* liability.²⁷⁶

Illustrative of the SEC's position is *Black & Co., Inc.*,²⁷⁷ in which the administrative law judge expressly rejected the respondent's contentions that *respondeat superior* and controlling persons liability were inapplicable to administrative disciplinary proceedings.²⁷⁸ R.W. Pressprich & Co., the broker-dealer respondent in *Black & Co.*, did not appeal the administrative law judge's initial decision to the Commission or to the court of appeals. Thus, the Court of Appeals for the District of Columbia Circuit has not had the opportunity to pass upon the *respondeat superior* issue in the context of an SEC administrative disciplinary proceeding.

Although the United States Court of Appeals for the Second Circuit noted the issue in *SEC v. Geon Industries, Inc.*,²⁷⁹ it disposed of the case on other grounds. Indeed, the only court of appeals to decide the issue squarely was the Sixth Circuit in *Armstrong, Jones & Co. v. SEC*.²⁸⁰ There, the court expressly upheld the SEC's right to sanction a broker-dealer in administrative disciplinary proceedings for the willful violation of the securities laws by its agents based upon the doctrine of *respondeat superior*.²⁸¹

It is clear that if a broker-dealer breaches its duty to supervise under section 15(b)(4)(E) of the 1934 Act, the firm may incur liability for the violative acts of its agents and employees in three separate forums: an SEC administrative disciplinary action,²⁸² an SEC civil injunctive action;²⁸³ and a private damage action.²⁸⁴ It is unclear, however, except perhaps in the Sixth Circuit, whether a broker-dealer that can prove adequate supervision under section 15(b)(4)(E) and good faith under section 20(a) will be liable without fault under the agency law principle of *respondeat*

276. See, e.g., *SEC v. Charles A. Morris & Assocs.*, 386 F. Supp. 1327, 1335 (W.D. Tenn. 1973); *Sutro Bros. & Co.*, 41 S.E.C. 470, 479 (1963); *Cady Roberts & Co.*, 40 S.E.C. 907, 911 (1961); *H.F. Schroeder & Co.*, 27 S.E.C. 833, 837 (1948).

277. SEC Ad. Pro. File No. 3-3460 (July 12, 1974), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,921 (opinion of SEC ALJ).

278. *Id.* at 84,382-83.

279. 531 F.2d 39, 55 n.21 (2d Cir. 1976).

280. 421 F.2d 359 (6th Cir.), *cert. denied*, 389 U.S. 958 (1970).

281. *Id.* at 361-62.

282. See, e.g., *Berdahl v. SEC*, 572 F.2d 643 (8th Cir. 1978); Richard L. Feldman, SEC 1934 Act Release No. 10,530 (Nov. 29, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,626.

283. See, e.g., *SEC v. Geon Indus. Inc.*, 531 F.2d 39 (2d Cir. 1976); *SEC v. Lum's (Lehman Bros.)*, 365 F. Supp. 1046 (S.D.N.Y. 1973).

284. See, e.g., *Delporte v. Shearson, Hammill & Co.*, 548 F.2d 1149, 1154 (5th Cir. 1977); *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203 (D. Mass. 1978).

superior for its employees' violations in an SEC administrative disciplinary action.

In an appropriate case, however, defense counsel should be able to convince the courts to reject the application of *respondeat superior* liability — liability without fault — in SEC administrative disciplinary actions. In any event, defense counsel should be aware of the ramifications of “the rather thorny controlling person — respondeat superior issue.”²⁸⁵

VIII. SETTLEMENT CONSIDERATIONS

Prior to 1975, the 1934 Act did not expressly authorize a broad range of flexible sanctions in an SEC administrative disciplinary proceeding. Either a registrant or a person associated with a registrant could be censured, suspended for a period not exceeding one year, or barred.²⁸⁶ The 1934 Act, as amended in 1975, now specifically authorizes the Commission to place limitations on the activities, functions, or operations of a broker-dealer or any person associated or seeking to become associated with a

285. *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 48 n.19 (2d Cir. 1978), *modified*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,525, *cert. denied*, 99 S. Ct. 642 (1978).

286. *See* 15 U.S.C. § 78o(b)(7) (1970).

During the 1960's, the enforcement staff began to deal with disciplinary cases in which censure was deemed too lenient, and across-the-board suspension of registration or suspension from association with a broker-dealer was deemed too severe. For example, a three-month suspension of broker-dealer registration based upon activities of an officer or manager would injure directly the remaining innocent employees of the registrant. Furthermore, when the prohibited activities occurred in only one branch office, a sanction curtailing activities in every office of a national broker-dealer firm would constitute overkill. Consequently, despite the absence of express statutory authorization, in consent settlements in the last fifteen years, the enforcement staff has designed various tailor-made sanctions in an effort to fit the sanction to the particular violation. By designing innovative and individualized sanctions, the enforcement staff enabled the Commission to dispose of the bulk of its disciplinary actions in consent settlements, rather than pursuing full-scale litigation.

Mathews, *A.L.I. Proposed Federal Securities Code: Part XV — Administration and Enforcement*, 30 VAND. L. REV. 465, 497 (1977)(footnote omitted).

Thus, in consent settlements, often only certain portions of firm's business activities were suspended. Revised supervisory and operating procedures were required. Limitations were imposed with respect to the types of business activities in which an individual could engage. Profits earned on certain activities were donated to charities. Restitution to injured investors was accomplished.

Id. at 497 n.192. *See also* Sporkin, *SEC Developments in Litigation and the Molding of Remedies*, 29 BUS. LAW. 121 (1974); Sporkin, *Statements in Quotes: A Regulator Responds*, in THE JOURNAL OF ACCOUNTANCY, Sept. 1979, at 100-04 (Emanuel Saxe Distinguished Accounting Lecture, at Bernard M. Baruch College (December 18, 1978)).

broker-dealer.²⁸⁷

In the overwhelming majority of SEC enforcement actions, a consent settlement is the most effective disposition for the clients involved.²⁸⁸ This is particularly true when the enforcement action is an administrative disciplinary proceeding in which the staff possesses maximum flexibility in tailoring an appropriate sanction to fit the peculiarities of a particular case.²⁸⁹

Since an injunction may trigger a host of direct and indirect statutory disqualifications,²⁹⁰ defense counsel may find it advantageous to negotiate a consent settlement in an administrative disciplinary proceeding rather than risk litigation of a civil injunctive action.²⁹¹ Although the securities statutes do not provide for ancillary relief in administrative disciplinary proceedings, by offering restitution, disgorgement of profits, or other types of repayment or reimbursement, a respondent may be able to achieve settlement with a less severe sanction than otherwise would be negotiable.²⁹²

287. 15 U.S.C. § 78o(b)(4), (6) (1976).

288. See Mathews, *Effective Defense of SEC Investigations: Laying the Foundation for Successful Disposition of Subsequent Civil, Administrative and Criminal Proceedings*, 24 EMORY L.J. 567 (1975).

In representing witnesses in SEC investigations, and particularly in attempting to bring an investigation to a timely conclusion by negotiating a consent settlement in some type of formal enforcement action to be instituted, counsel must be cautious to maintain that important sense of credibility with the SEC and its Staff. Vigorous, alert representation of a client in the investigatory stage, including preparation of a forceful Wells Committee Submission, coupled with astute negotiations in an atmosphere of complete credibility, should, in the view of the writer, lead to a satisfactory settlement of the overwhelming majority of a securities attorney's enforcement cases, rather than pursuit of lengthy, expensive, arduous and usually harmful litigation.

Id. at 634. See also A. MATHEWS, NEGOTIATING SEC CONSENT DECREES: TARGETS AND TACTICS FOR SETTLING CIVIL INJUNCTIVE ACTIONS (1979).

289. For a helpful article in this regard, see Thomforde, *supra* note 10.

290. See Mathews, *Liability of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105, 142-46 (1975).

291. See, e.g., Hycel, Inc., SEC 1934 Act Release No. 14,981 (July 20, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,676; Government Employees Ins. Co., SEC 1934 Act Release No. 12,930 (Oct. 27, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,750; Ampex Corp., SEC 1934 Act Release No. 12,736 (Aug. 25, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,699; Jo M. Ferguson, SEC 1933 Act Release No. 5523 (Aug. 21, 1974); Arthur Andersen & Co., SEC Accounting Series Release No. 157 (July 8, 1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,179; Touche Ross & Co., SEC Accounting Series Release No. 153 (Feb. 25, 1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,175.

292. See, e.g., Government Employees Ins. Co., SEC 1934 Act Release No. 12,930 (Oct. 27, 1976), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,750; Financial Programs, Inc., SEC 1934 Act Release No. 11,312 (Mar. 24, 1975), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,146; Kippen & Co., Inc., SEC 1934 Act Release No. 10,935 (July 30, 1974); Butcher & Sherrerd, SEC 1934 Act Release No. 9894 (Dec. 11, 1972), [1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,135.

Often a consent settlement proposal more likely will be accepted if the respondent agrees to adopt new internal procedures designed to help prevent a recurrence of the violations charges.²⁹³ With regard particularly to consent settlements of rule 2(e) proceedings against accounting firms, the SEC has recently required "peer review" provisions whereby the respondent firm's procedures are inspected, reviewed, and commented upon by designated professionals outside the firm.²⁹⁴

One further aspect of consent settlements concerns whether the legal principles articulated by the Commission and its enforcement staff will serve as *stare decisis* or persuasive precedent in future actions, notwithstanding that such principles did not evolve in a traditional adversary proceeding. When complex legal issues have been fully litigated in SEC administrative enforcement proceedings, courts will sometimes defer to the SEC's administrative expertise and adopt the legal principles the SEC deems appropriate.²⁹⁵ Consent settlements fare about as well as fully liti-

293. See, e.g., E.F. Hutton & Co., SEC 1934 Act Release Nos. 15,537, 15,538 (Jan. 30, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,938; Blyth, Eastman Dillon & Co., SEC 1934 Act Release No. 10,565 (Dec. 19, 1973); Faberge, Inc., SEC 1934 Act Release No. 10,174 (May 25, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,378; Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968).

294. See, e.g., Ernst & Ernst, SEC Accounting Series Release No. 248 (May 31, 1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,270; Haskins & Sells, SEC Accounting Series Release No. 241 (Feb. 10, 1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,263; Seidman & Seidman, SEC Accounting Series Release Nos. 196 (Sept. 1, 1976), 196A (Nov. 18, 1976), 6 FED. SEC. L. REP. (CCH) ¶¶ 72,218-218A. See generally Burton, *supra* note 4.

295. See, e.g., E.I. duPont de Nemours & Co. v. Collins, 432 U.S. 46 (1977). The Court in *Collins* stated:

A reviewing court is also to be guided by the "venerable principle that the construction of a statute by those charged with its execution should be followed unless there are compelling indications that it is wrong . . ." *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381 (1969). "[C]ontemporaneous construction is entitled to great weight . . . even though it was applied in cases settled by consent rather than in litigation." *FTC v. Mandel Bros.*, 359 U.S. 385, 391 (1959). The Commission's . . . determination . . . rested "squarely in that area where administrative judgments are entitled to the greatest amount of weight by appellate courts. It is the product of administrative experience, appreciation of the complexities of the problem, realization of the statutory policies, and responsible treatment of the uncontested facts." *SEC v. Chenery Corp.*, 332 U.S. 194, 209 (1947). In rejecting the conclusion of the Commission, the Court of Appeals substituted its own judgment for that of the agency charged by Congress with that responsibility.

Id. at 54-57.

But see *SEC v. Sloan*, 436 U.S. 103 (1978). In *Sloan*, the Court stated:

Nor does the existence of a prior administrative practice, even a well-explained one, relieve us of our responsibility to determine whether that practice is consistent with the agency's statutory authority . . . "[T]he courts are the final authorities on issues of statutory construction" . . . and "are not obligated to stand aside and rubber-stamp their affirmance of administrative decisions that they deem inconsis-

gated matters; sometimes the courts rely upon them as precedent,²⁹⁶ and sometimes they do not.²⁹⁷

IX. *RES JUDICATA* AND COLLATERAL ESTOPPEL CONSIDERATIONS

The collateral estoppel effect of SEC civil injunctive judgments was recently decided in *Parklane Hosiery Co. v. Shore*.²⁹⁸ In *Shore*, the Court overruled the contrary court of appeals precedent of *Rachal v. Hill*²⁹⁹ and held that a plaintiff in a private damage action may, in some circumstances, make "offensive" use of the findings of fact made by the court against a defendant in a parallel SEC civil injunctive action through the doctrine of collateral estoppel.³⁰⁰ The Court sanctioned such use of collateral estoppel in a private damage action where a defendant is ordinarily entitled to a jury trial even though he is never entitled to a jury trial in an SEC civil injunctive action. Thus, in some circumstances, a defendant in a private damage action may be precluded from relitigating before a jury the same issues that were decided against him in a parallel, nonjury SEC civil injunctive action.³⁰¹

tent with a statutory mandate or that frustrate the congressional policy underlying a statute." *NRLB v. Brown*, 380 U.S. 278, 291 (1965). *Volkswagenwerk v. Federal Maritime Comm'n*, 390 U.S. 261, 292 (1968). And this is just such a case — the construction placed on the statute by the Commission, though of longstanding, is . . . inconsistent with the statutory mandate And our clear duty in such a situation is to reject the administrative interpretation of the statute.

Id. at 118-19.

296. See, e.g., *Steadman v. SEC*, 603 F.2d 1126 (5th Cir. 1979), where the court stated: Steadman's attack on the precedential value of *Provident* [44 S.E.C. 442 (1970)] is without merit. Although that opinion was issued in connection with an offer of settlement, the Commission's construction of the securities laws in settled cases as well as litigated ones is entitled to great weight.

Id. at 1136 n.15.

297. See, e.g., *United States v. Van de Carr*, 343 F. Supp. 993 (C.D. Cal. 1972), where the court refused to rely upon the SEC opinion in connection with the administrative consent decree in *Sutro Bros. & Co.*, 41 S.E.C. 443 (1963), and stated:

This administrative decision cited by the Government resulted from a stipulation by the broker that the Commission could make findings as permitted by law and impose an appropriate penalty In essence, the cited S.E.C. decision is in the nature of an uncontested opinion which did not result from adversary . . . advocacy of the applicable law. Absent more persuasive legal authority . . . this Court is unable to permit a jury to convict a defendant of felony violations under 15 U.S.C. § 78ff(a).

Id. at 1008.

298. 99 S. Ct. 645 (1979).

299. 435 F.2d 59 (5th Cir. 1970), cert. denied, 403 U.S. 904 (1971).

300. 99 S. Ct. at 651-52.

301. For more complete discussions of the Court's opinion in *Shore*, see Kaminsky, *Collateral Estoppel and Jury Trial Rights*, 12 REV. SEC. REG. 945 (1979); Pickholz & Brodsky,

On the other hand, consent injunctive decrees generally do not contain findings of fact and conclusions of law, nor are they required to. Consent injunctions in SEC enforcement actions, therefore, would not have a *res judicata* or collateral estoppel effect in a parallel private damage action.³⁰²

But consent orders in an SEC administrative proceeding may have collateral estoppel ramifications. Although there do not appear to be any opinions elaborating upon the possible *res judicata* and collateral estoppel effects of SEC administrative disciplinary orders,³⁰³ at least since *United States v. Utah Construction & Mining Co.*,³⁰⁴ it has been generally recognized that federal courts may give collateral estoppel effect to administrative findings. Thus, the Supreme Court's *Shore* rule may also apply to fully litigated SEC administrative proceedings.³⁰⁵

An open area concerns consent decrees in SEC administrative disciplinary actions. Unlike consent injunctive decrees without findings, in a settled administrative order the Commission must make a finding of "willful violation" of the law, notwithstanding that the decree contains the boilerplate "without admitting or denying" language. In order to protect against unforeseen collateral estoppel consequences arising from such required finding, counsel in administrative settlements should condition their client's consent upon inclusion of express language in the settlement that it shall not have *res judicata* or collateral estoppel effect in other actions.³⁰⁶

An Assessment of Collateral Estoppel and SEC Enforcement Proceedings After Parklane Hosiery Co. v. Shore, 28 AM. U.L. REV. 37 (1978).

302. For a discussion of the criteria applicable to the question of whether a consent injunctive decree is admissible into evidence as an admission in a criminal prosecution, see *United States v. Cook*, 557 F.2d 1149 (5th Cir. 1977), *cert. denied sub nom. Johnson v. United States*, 434 U.S. 1020 (1978). For comparable considerations in a private damage action, see *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887 (2d Cir. 1976). But a consent injunctive decree under the registration provisions of § 5 of the 1933 Act, 15 U.S.C. § 77e (1976), will not, pursuant to collateral estoppel, prevent the SEC from filing a subsequent injunctive action against the same defendant on the same facts alleging fraud violations. See *SEC v. Dimensional Entertainment Corp.*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,536 (S.D.N.Y. Aug. 17, 1978).

303. In one reported case, the court *without explanation*, refused to grant collateral estoppel effect in a private damage action to a previous SEC administrative disciplinary consent settlement (based upon stipulated facts). See *Pitofsky v. Brucker*, 291 F. Supp. 321 (S.D.N.Y. 1966).

304. 384 U.S. 394 (1966).

305. See Pickholz & Brodsky, *supra* note 301, at 56-59.

306. See *United States v. International Bldg. Co.*, 345 U.S. 502 (1953); James, *Consent Judgments as Collateral Estoppel*, 108 U. PA. L. REV. 173 (1959); Note, *Collateral Estoppel by Judgment*, 52 COLUM. L. REV. 647 (1952); Note, *The Collateral Estoppel Effect of Administrative Agency Actions in Federal Civil Litigation*, 46 GEO. WASH. L. REV. 65 (1977). See also *Concrete Materials of Ga., Inc. v. NLRB*, 440 F.2d 61 (5th Cir. 1971); *Purvis v. Great Falls*

X. ENFORCEMENT OF THE FOREIGN CORRUPT PRACTICES ACT THROUGH ADMINISTRATIVE PROCEEDINGS

The enforcement net of the SEC was expanded significantly when Congress enacted the Foreign Corrupt Practices Act of 1977 (FCPA).³⁰⁷ The statute's title, however, is misleading. The FCPA's proscriptions and requirements apply to wholly domestic concerns as well as to multinational business entities with foreign activities, and it regulates many business practices that are not necessarily corrupt.³⁰⁸

The FCPA has two principal aspects. First, section 103³⁰⁹ and section 104³¹⁰ proscribe certain corrupt payments by issuers or domestic concerns to or on behalf of foreign governmental or political officials. Second, section 102³¹¹ sets forth extensive book and recordkeeping, and internal accounting controls requirements for SEC-registered issuers. The FCPA provides for enforcement of its provisions through criminal prosecution by the Department of Justice and through civil injunctive action by the SEC (with respect to issuers) and by the Department of Justice (with respect to domestic concerns). However, the question has been raised whether the SEC may enforce the FCPA, particularly the book and recordkeeping and internal accounting controls provisions of section 13(b)(2),³¹² through litigation of section 15(c)(4)³¹³ administrative proceedings.³¹⁴

To date, the SEC has not instituted any administrative enforcement proceedings in FCPA cases.³¹⁵ However, in 1978 in the *Hycel* case,³¹⁶ involv-

Bldg. & Constr. Trades Council, 266 F. Supp. 661 (D. Mont. 1967); *Ulrich v. Ethyl Gasoline Corp.*, 2 F.R.D. 357 (W.D. Ky. 1942); *Kaminsky*, *supra* note 301.

307. Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified in scattered sections of 15 U.S.C.). See H.R. REP. NO. 831, 95th Cong., 1st Sess. (1977) (conference committee report). See generally Best, *The Foreign Corrupt Practices Act*, 11 REV. SEC. REG. 975 (1978); *Foreign Corrupt Practices Act of 1977 and the Regulation of Questionable Payments*, 34 BUS. LAW. 623 (1979); Notification of Enactment of Foreign Corrupt Practices Act of 1977, SEC Accounting Series Release No. 242 (Feb. 16, 1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,264.

308. See A. LEVENSON, A. MATHEWS & H. PITT, *THE FOREIGN CORRUPT PRACTICES ACT OF 1977: DO YOU KNOW THIS ACT COVERS DOMESTIC BUSINESS ACTIVITIES?* (1978); Baruch, *The Foreign Corrupt Practices Act*, HARV. BUS. REV. 32 (Jan.-Feb. 1979).

309. 15 U.S.C. §§ 78dd-1, ff(c) (Supp. I 1977).

310. 15 U.S.C. § 78dd-2 (Supp. I 1977).

311. 15 U.S.C. § 78m(b)(2) (Supp. I 1977).

312. 15 U.S.C. § 78m(b)(2) (Supp. I 1977).

313. 15 U.S.C. § 78o(c)(4) (1976).

314. See, e.g., Block & Barton, *Administrative Proceedings to Enforce the Foreign Corrupt Practices Act*, 7 SEC. REG. L.J. 40 (1979).

315. In one recent consent settlement in a rule 2(e) administrative disciplinary proceeding, however, the SEC disciplined a lawyer who, as general counsel to a public corporation, engaged in "improper professional conduct" by participating in the corporation's payment of secret, unrecorded political contributions to candidates for public office in the Bahamas. See Mary Jane Melrose, SEC Ad. Pro. File No. 3-5388 (May 1, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,578.

316. *Hycel, Inc.*, SEC 1934 Act Release No. 14,981 (July 20, 1978), [1978 Transfer

ing undisclosed corporate perquisites, in a section 15(c)(4) consent settlement the Commission criticized an issuer's inadequate system of internal controls, caused the issuer to undertake to establish and maintain adequate internal controls, and made reference to the internal controls provisions of newly amended section 13(b)(2) of the 1934 Act.³¹⁷

Moreover, both the former³¹⁸ and present³¹⁹ General Counsel of the SEC have suggested that administrative disciplinary proceedings pursuant to section 15(b)(4) of the 1934 Act could be utilized for enforcement of the FCPA. In light of *Hycel* and the publicly expressed views of high-level SEC staff members, one can reasonably expect that in future enforcement cases against corporate issuers involving foreign or domestic questionable payments, undisclosed corporate perquisites, or other financial activities not properly recorded in the issuer's books and records, disposition by consent settlement in administrative section 15(c)(4) proceedings will be an available option in appropriate circumstances. One can further expect that in such settlements, in addition to correcting the issuer's deficient filings, the enforcement staff will require ancillary relief by undertakings that will

Binder] FED. SEC. L. REP. (CCH) ¶ 81,676.

317. The Commission stated:

Because of Hycel's past lack of an adequate procedure for authorizing, reviewing and verifying the business purpose of expenses of Moran and others, it is appropriate that Hycel establish a procedure whereby such expenditures are authorized, reviewed and verified by persons who are independent of the persons submitting the requests for reimbursement The adoption of appropriate procedures is particularly important in view of the recent enactment of Section 13(b)(2) of the Exchange Act, which provides that all reporting companies must make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer, and devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that stated objectives, with respect to execution of transactions, recordation of transactions, and access to assets, are achieved.

Id. at 80,730.

318. Former SEC General Counsel Harvey Pitt has stated:

Well, I think that the basic thing to bear in mind is that the Foreign Corrupt Practices Act has been built into the Securities and Exchange Act, at least as it affects publicly held issuers In this context the legislative history makes quite clear . . . that the normal panoply of Commission enforcement remedies . . . even administrative proceedings, were available.

Foreign Corrupt Practices Act of 1977 and the Regulation of Questionable Payments, supra note 307, at 629 (emphasis supplied).

319. Present SEC General Counsel Ralph Ferrara speculated that § 15(c)(4) administrative proceedings, which seek to remedy particular violations of the book and recordkeeping and internal accounting controls provisions of new § 13(b)(2), could become increasingly important in the SEC's enforcement program. *See* 451 SEC. REG. & L. REP. (BNA) D-1 (May 3, 1978).

ensure that independent audit committees establish and implement systems of internal accounting controls and book and recordkeeping sufficient to achieve compliance with section 102 of the FCPA.³²⁰ As one commentator has noted, a principal focus of enforcement of the FCPA by the Commission may be corporate *directors*:

[B]ased on past enforcement investigations in which the SEC has reviewed the performance of the board of directors, it is to be expected that the directors of a company — especially those serving on the audit committee — will bear a share of the blame and liability arising out of violations of the act by their company. Having pushed so hard for the general establishment of audit committees, the SEC will not be hesitant in seeing that they are active in reviewing management's compliance with the record-keeping, internal controls, and antibribery provisions of the Foreign Corrupt Practices Act of 1977.³²¹

XI. EFFECT OF THE AMERICAN LAW INSTITUTE'S PROPOSED FEDERAL SECURITIES CODE

Under the leadership of Professor Louis Loss of Harvard Law School, the American Law Institute, with substantial assistance of the interested committees and sections of the American Bar Association, spent over a decade developing a proposed Federal Securities Code (Code).³²² Negoti-

320. Codified as § 13(b)(2) of the 1934 Act, 15 U.S.C. § 78m(b)(2) (Supp. I 1977). *See generally* SEC v. Ormand Indus., Inc., [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,046 (D.D.C. May 1977) (consent injunction); Hycel, Inc., SEC 1934 Release No. 14,981 (July 20, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,676.

In 1978, then SEC General Counsel Harvey Pitt opined that § 13(a) of the 1934 Act, 15 U.S.C. § 78m(a) (1976), supplemented by the new requirements of § 13(b)(2), 15 U.S.C. § 78m(b)(2) (Supp. I 1977), by implication authorizes the SEC to adopt rules requiring public companies to establish independent audit committees. *See* Memorandum of SEC General Counsel (March 2, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,535. To date, the SEC has proposed no such rule and it is unlikely that the Commission will do so. However, the SEC has recently passed two rules under the FCPA, which together have been labeled Regulation 13B-2. *See* 17 C.F.R. §§ 240.13b2-1, -2 (1979). *See generally* Promotion of the Reliability of Financial Information and Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices; Final Rules, SEC 1934 Act Release No. 15,570 (Feb. 15, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,959. The Commission has also published for comment, but not yet promulgated, additional proposed rules that would amend form 10-K, 17 C.F.R. § 249.310 (1979), Regulation 14A, 17 C.F.R. § 240.14a-1 to -12 (1979), and Regulation 5-K, 17 C.F.R. § 229.20 (1979), to require a statement of management respecting compliance or noncompliance with the internal accounting controls provisions of § 13(b)(2), 15 U.S.C. § 78m(b)(2) (Supp. I 1977). *See* Statement of Management on Internal Accounting Control, SEC 1934 Act Release No. 15,772 (Apr. 30, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,063.

321. Baruch, *supra* note 308, at 50.

322. ALI FEDERAL SECURITIES CODE (Proposed Official Draft 1978) [hereinafter cited as

ations are presently being conducted with the SEC to determine whether the Commission will support legislative enactment of the Code. It is, therefore, worthwhile to note briefly how the Code would affect litigation of SEC administrative enforcement proceedings.³²³

Sections 1808 through 1817 of the Code govern the adjudication of administrative proceedings by the Commission.³²⁴ Under the Code, the SEC generally would be able to litigate the same types of administrative disciplinary proceedings now pursued under the 1934, Advisers, and 1940 Acts against broker-dealers, investment advisers, investment companies, and persons associated or seeking to become associated therewith.³²⁵ Similarly, the SEC could pursue comparable administrative proceedings respecting defective registration statements as it presently pursues in 1933 Act "stop-order" proceedings,³²⁶ and respecting deficient annual, periodic, or other reports as it presently pursues in 1934 Act section 15(c)(4) proceedings.³²⁷

The Code does not squarely address the issue of whether the SEC should be allowed to continue to pursue administrative disciplinary proceedings against lawyers, accountants, and other independent professionals as it presently does pursuant to rule 2(e) of the SEC Rules of

PROPOSED CODE]. See generally Lowenfels, *The Case Against the Proposed Federal Securities Code*, 65 VA. L. REV. 615 (1979); ABA Committee on Federal Regulation of Securities, *ALI Proposed Federal Securities Code*, 34 BUS. LAW. 345 (1978); Symposium, *The American Law Institute's Proposed Federal Securities Code (pt. 1)*, 30 VAND. L. REV. 311 (1977); Symposium, *The American Law Institute's Proposed Federal Securities Code (pt. 2)*, 32 VAND. L. REV. 455 (1979). See also Mathews, *supra* note 286.

323. The purposes of the PROPOSED CODE are threefold:

(1) simplification of an inevitably complex body of law in the light of some four decades of administration and litigation; (2) elimination (so far as possible) of duplicate regulation; and (3) reexamination of the entire scheme of investor protection with a view to increasing its efficiency and doing so, in President Roosevelt's words, "with the least possible interference to honest business."

PROPOSED CODE, *supra* note 322, at XV (footnote omitted).

324. *Id.* at 663-82.

325. See *id.* §§ 1809, 1815, at 667, 674; notes 28-43 and accompanying text *supra*. See also Mathews, *supra* note 286, at 496-99, 507-08.

The PROPOSED CODE also provides for SEC administrative disciplinary proceedings against (i) self-regulatory organizations such as stock exchanges, the N.A.S.D., and registered clearance agencies and their members or related persons, PROPOSED CODE, *supra* note 322, § 810, at 671-72; (ii) transfer agents, *id.* § 1811, at 672-73; (iii) registered securities information processors, *id.* § 1812, at 673; and (iv) mutual service companies, *id.* § 1816, at 675. See also Mathews, *supra* note 286, at 506-08.

326. See, e.g., PROPOSED CODE, *supra* note 322, § 1808(d), at 664; notes 23-24 and accompanying text *supra*. See also Mathews, *supra* note 286, at 493-96.

327. See, e.g., PROPOSED CODE, *supra* note 322, § 1808(c), at 664; notes 31-36 and accompanying text *supra*.

Practice.³²⁸ The Code does not proscribe such proceedings, nor does it expressly sanction them. The Code's silence in this regard, however, was intentional. The drafters left to the federal courts the decision whether, absent a specific legislative grant, the SEC possesses an inherent, implied power to administratively discipline independent professionals, such as attorneys and accountants, who practice before it.³²⁹

Under the Code, the Commission would retain the right to require and to publish reports of investigation or investigative statements comparable to 1934 Act section 21(a) reports and statements.³³⁰ Section 1806(d)(3) of the Code, however, contains a new provision designed to protect individual rights from unreviewable adverse governmental publicity:

If it is practicable to do so, a person who is or will be the subject of adverse publicity as a result of Commission action [conducting a public investigation or publicly disseminating a report of investigation or investigative statement] shall be given . . . (A) a reasonable opportunity to state his position on the record in the investigation . . . , and (B) advance notice of the publication . . . together with a reasonable opportunity to prepare a response in advance of the publication.³³¹

Professor Loss has commented that this new provision "is addressed to the peculiar problem of the subject of an investigatory report who is without a judicial remedy or even a judicial defense."³³² This provision reflects the sensitivity that historically the courts,³³³ and more recently the Admin-

328. See notes 44-49 and accompanying text *supra*.

329. In the accompanying notes, Professor Loss describes the controversy over rule 2(e) and whether it should be legislatively condoned or proscribed:

This draft goes back to present law . . . that is to say, it remains silent, neither enlarging nor diminishing whatever implicit authority the Commission has. . . .

All this reflects a good deal of tension among members of the securities Bar, some of whom question the wisdom of giving disciplinary authority to a prosecutory body and suggest that the SEC's traditional claim to have that authority has had a tendency on occasion to stifle vigorous representation of clients

In view of the level of controversy, silence seems the least imperfect course. PROPOSED CODE, *supra* note 322, at 643-45. See also 5 U.S.C. § 500(b), (d)(2) (1976).

330. See PROPOSED CODE, *supra* note 322, § 1806(c), (d), at 656-57; notes 50-57 and accompanying text *supra*. See also Mathews, *supra* note 286, at 484-87.

331. PROPOSED CODE, *supra* note 322, at 657.

332. *Id.*

333. See, e.g., SEC v. Harrison, 80 F. Supp. 226, 229 (D.D.C. 1948) (it is a well recognized principle of administrative law that investigations ought not to be so conducted that harmful publicity will be used in lieu of sanctions provided by law); cf. Silver King Mines, Inc. v. Cohen, 261 F. Supp. 666 (D. Utah 1966) (injunction imposed against SEC for publicizing misleading press release respecting charges in pending civil injunctive action).

istrative Conference³³⁴ have demonstrated for the need to adequately protect persons from unfair injury by adverse agency publicity.

Under the Code, imposition of any administrative disciplinary sanction must be "in the public interest or for the protection of investors."³³⁵ Thus, the Code abandons the troublesome and confusing term "willful," substituting the standards of "scienter" and "without reasonable justification or excuse" in connection with imposition of administrative disciplinary sanctions.³³⁶ Although the term "scienter" is defined,³³⁷ discerning what the phrase "without reasonable justification or excuse" means under the Code may be just as confusing as determining the meaning of "willful" under existing law.³³⁸

The Code does not purport to deal with the burden of proof applicable to administrative disciplinary proceedings. It neither adopts the traditional "preponderance of the evidence" standard, nor the "clear and convincing" standard of the *Collins* and *Whitney* cases.³³⁹ Nor does it deal with the "compelling reasons" or "burden of justification" test of the *Steadman* case applicable to imposition of sanctions.³⁴⁰

The Code grants the SEC neither the authority to impose monetary fines as an administrative sanction nor the authority in administrative disciplinary proceedings to order such ancillary relief as restitution, disgorgement, or rescission.³⁴¹

Section 1809 of the Code³⁴² closes to some degree a loophole in the present statutory framework embraced by section 15(b)(6) of the 1934 Act.³⁴³

334. See ADVERSE PUBLICITY, ADMINISTRATIVE CONFERENCE'S RECOMMENDATION 73-1 (June 8, 1973); E. GELLHORN, ADVERSE PUBLICITY BY ADMINISTRATIVE AGENCIES (April 15, 1973) (report prepared for Compliance and Enforcement Committee of the Administrative Conference of the United States); Gellhorn, *supra* note 30, at 1394-93.

335. See PROPOSED CODE, *supra* note 322, § 1804(b), at 645, which applies generally to all Commission order-entering; notes 113-24 and accompanying text *supra*.

336. See PROPOSED CODE, *supra* note 322, § 1809, at 667-68; notes 101-12 and accompanying text *supra*.

337. "Scienter" is defined as follows:

A person makes (or . . . causes or gives substantial assistance to the making of) a misrepresentation with "scienter" if he knows that he is making a misrepresentation (or a misrepresentation is being made) or acts in reckless disregard of whether that is so.

PROPOSED CODE, *supra* note 322, § 229.50, at 154-55.

338. Compare *id.* § 299.34, at 144 with *id.* § 287 note (5)(c), at 114-15. See also Mathews, *supra* note 286, at 499.

339. See notes 69-78, 92-100 and accompanying text *supra*.

340. See notes 79-91 and accompanying text *supra*.

341. See Mathews, *supra* note 286, at 500.

342. PROPOSED CODE, *supra* note 322, at 667-70.

343. 15 U.S.C. § 78o(b)(6) (1976).

Since the 1975 amendments to the 1934 Act, the Commission has only been able to administratively discipline "any person associated, or seeking to become associated, with a broker or dealer."³⁴⁴ From 1964 to 1975, however, the Commission had a much broader power: it could administratively discipline "any person," even though the person was not a securities professional or in any way associated with a broker-dealer.³⁴⁵ "This statutory framework enabled the Commission to speak out administratively in an *ad hoc* adjudicatory context in important areas of the law, even in instances in which broker-dealers or associated persons were not involved in the prohibited conduct."³⁴⁶

The SEC's present more restrictive authority raises a question whether the Commission may adjudicate disciplinary proceedings against a person who was associated with a broker-dealer when violations occurred but who terminated such association before administrative disciplinary proceedings were begun and is not seeking to become associated again with any broker-dealer.³⁴⁷ Section 1809 succeeds in closing a substantial part of this loophole by allowing the Commission to proceed administratively against any person who *was* associated with a broker-dealer *at the time of the conduct alleged* to be in violation of the law.³⁴⁸ However, the Code does not close the loophole all the way: it does not grant the SEC its 1964-1975 power to adjudicate administrative disciplinary proceedings against a person who has violated the statute but who has never been associated with a broker-dealer, investment adviser, or investment company.³⁴⁹ One way to correct this would be to provide the SEC, either in the Code or in separate legislation, with some flexible form of administrative "cease and desist" or comparable power that would reach "any person" or at least a broader class of persons than present section 15(b)(6) of the 1934 Act or proposed section 1809 of the Code.³⁵⁰

The Code's treatment of secondary liability, including the doctrines of aiding and abetting, conspiracy, controlling persons provisions, *respondeat superior*, and duty to supervise,³⁵¹ is interesting and quite important. Even though the Supreme Court has not yet specifically determined whether and

344. *Id.*

345. See § 15(b)(7) of the 1934 Act, 15 U.S.C. § 78o(b)(7) (1970).

346. Mathews, *supra* note 286, at 501; *cf.* Investors Mgt. Co., 44 S.E.C. 633 (1971) (tippee situations).

347. See Mathews, *supra* note 286, at 501.

348. PROPOSED CODE, *supra* note 322, at 667.

349. See Mathews, *supra* note 286, at 502.

350. See notes 383-411 and accompanying text *infra*. See also Mathews, *supra* note 286, at 502-03.

351. See notes 214-85 and accompanying text *supra*.

to what extent the criminal law doctrines of aiding and abetting and conspiracy apply to civil and administrative enforcement of the federal securities laws,³⁵² the Code contains broad aider and abettor provisions applicable in both the civil and administrative contexts.³⁵³ The Code also contains a "controlling persons" provision comparable to the existing 1933³⁵⁴ and 1934³⁵⁵ Acts provisions, but makes it applicable only to civil damage actions and other private actions.³⁵⁶ SEC injunctive actions would be governed under the Code by common law agency concepts,³⁵⁷ and administrative disciplinary proceedings would be governed by the duty to supervise.³⁵⁸

Under present law, section 15(b)(4)(E) of the 1934 Act,³⁵⁹ if a subordinate commits a statutory violation and if the broker-dealer firm or its supervisory personnel have failed reasonably to supervise the subordinate, either by reason of not establishing reasonably adequate supervisory procedures or not adequately implementing them, then both the broker-dealer firm and the supervisory personnel may be administratively disciplined for failure reasonably to supervise.³⁶⁰

The burden of proof of the underlying statutory violation, however, [is] on the SEC's Enforcement Division. Thus present and prior provisions of the 1934 Act have not made a failure to supervise unlawful *per se*; rather the statute has provided that a supervisory person or registrant may be sanctioned administratively only when the failure to supervise contributes to the commission of a statutory violation by a subordinate.³⁶¹

The Code has a more stringent "duty to supervise" provision. Section 1809(a)(5) makes the failure to supervise *per se* a ground for imposition of a disciplinary sanction without the necessity of proof that a subordinate committed a statutory violation.³⁶² Furthermore, whenever the enforcement staff establishes that a subordinate has committed a violation under

352. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court stated: "We need not consider whether civil liability for aiding and abetting is appropriate . . . , nor the elements necessary to establish such a cause of action." *Id.* at 192 n.7.

353. See PROPOSED CODE, *supra* note 322, § 2006(c)(1), at 746-47; *id.* § 1724(b), at 613-14.

354. See § 15 of the 1933 Act, 15 U.S.C. § 77o (1976).

355. See § 20(a) of the 1934 Act, 15 U.S.C. § 78t(a) (1976).

356. See PROPOSED CODE, *supra* note 322, § 1724, at 611-13.

357. See *id.* § 1724 note 2(b), at 612-13.

358. See *id.* § 1809(a)(5), at 668. See also *id.* § 1724 note 2(b), at 613.

359. 15 U.S.C. § 78o(b)(4)(E) (1976).

360. See notes 220-21 and accompanying text *supra*.

361. Mathews, *supra* note 286, at 504 (footnotes omitted).

362. PROPOSED CODE, *supra* note 322, at 668. The term "failure to supervise" is defined in *id.* § 1809(d), at 669.

the Code, contrary to existing law, the burden shifts and the supervisors and the registrant have the burden of proving reasonable supervision.³⁶³

Nevertheless, the Code's harsher "duty to supervise" concept is offset by its rejection of *respondeat superior* liability for brokerage firms in administrative disciplinary contexts when adequate supervision is proven.³⁶⁴ Pursuant to section 1809(c),³⁶⁵ if the subordinate who commits a statutory violation is an associate or employee "whose functions are solely clerical, ministerial, or in areas not subject to regulation under this Code,"³⁶⁶ then the SEC can sanction only the individual even if the firm has failed to supervise reasonably the employee.³⁶⁷

The procedural framework for all SEC administrative adjudications³⁶⁸ is provided in section 1817 of the Code.³⁶⁹ A discussion of the important administrative law concepts covered by this provision and governing the Commission's rule-making and order-entering functions is beyond the scope of this article. One historically sensitive area, however, is appropriate for comment: whether SEC administrative disciplinary proceedings should be adjudicated in a public as opposed to a private forum.³⁷⁰ Most of the securities statutes give the Commission discretion to adjudicate disciplinary proceedings either publicly or privately;³⁷¹ the recent trend has been to opt for public proceedings. Many private practitioners argue that all such proceedings should be private.³⁷² In 1964, the American Bar Association formally recommended that all such proceedings be private unless the Commission determines, after a private hearing, that investor protection requires a public proceeding.³⁷³ On the other hand, the writer, concededly representing a minority view in the securities bar, has always advocated that, like trials in the federal courts, all SEC administrative dis-

363. See *id.* § 1809(b)(2), at 668. See also Mathews, *supra* note 286, at 505.

364. See Mathews, *supra* note 286, at 505.

365. PROPOSED CODE, *supra* note 322, at 668.

366. *Id.*

367. See Mathews, *supra* note 286, at 505.

368. The PROPOSED CODE will not affect most of the practice and procedure issues discussed at notes 155-213 and accompanying text *supra*.

369. PROPOSED CODE, *supra* note 322, at 675-82. See also Mathews, *supra* note 286, at 508-18.

370. See Mathews, *supra* note 286, at 514-18. See also Gellhorn, *supra* note 30, at 1395 n.55.

371. See, e.g., § 22 of the 1934 Act, 15 U.S.C. § 78v (1976); § 41 of the 1940 Act, 15 U.S.C. § 80a-40 (1976); § 212 of the Advisers Act, 15 U.S.C. § 80b-12 (1976).

372. See, e.g., Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 896-97 (1967); Freeman, *A Private Practitioner's View of the Development of the Securities and Exchange Commission*, 28 GEO. WASH. L. REV. 18, 24 (1959).

373. 89 REPORTS OF THE AMERICAN BAR ASSOCIATION 135 (1964).

ciplinary proceedings should be adjudicated in a public forum.³⁷⁴

Section 1817(e) of the Code³⁷⁵ reserves to the SEC the discretion to determine when an administrative disciplinary proceeding should be public and when a proceeding should be private, except that contrary to existing law, section 1817(e)(1) provides that an adjudicatory proceeding "*shall be public when all the respondents so request.*"³⁷⁶

One of the more significant provisions of the Code, also beyond the scope of this article, is section 1818,³⁷⁷ concerning judicial review.³⁷⁸ Importantly, a person aggrieved by a final order of the Commission may obtain review in the United States Court of Appeals for the circuit in which he resides *or* in the District of Columbia Circuit.³⁷⁹ In light of the *Collins* and *Whitney* cases,³⁸⁰ the District of Columbia Circuit is a particularly appropriate forum in which to contest harsh SEC administrative disciplinary sanctions.

Legal literature both favorable³⁸¹ and in opposition³⁸² to legislative enactment of the Code is now being disseminated. Congressional enactment or rejection of the Code, however, will have little, if any, effect upon practice, procedure, and strategy that defense attorneys will employ in defending SEC administrative enforcement proceedings. Nevertheless, the thumbnail analysis provided above of the Code's treatment of SEC administrative proceedings may provide some basis for a better understanding of the implications of some of the provisions and principles of existing law.

XII. PROPOSED ADMINISTRATIVE CEASE AND DESIST REMEDY

Under the present statutes, the SEC may litigate administrative disciplinary proceedings against only certain classes of persons or entities: issuer registrants under the 1933 Act, issuer registrants under the 1934 Act, broker-dealers and persons associated or seeking to become associated therewith under the 1934 Act, and comparable classes of persons and entities

374. See Letter from A.F. Mathews to SEC Advisory Committee on Enforcement Policies and Practices (May 23, 1972), *reprinted in* MATHEWS, *supra* note 63, at 323.

375. PROPOSED CODE, *supra* note 322, at 681.

376. *Id.* (emphasis supplied).

377. *Id.* at 682-89.

378. See Mathews, *supra* note 286, at 519-33.

379. See PROPOSED CODE, *supra* note 322, § 1818(a), at 682; *cf.* § 25(a)(1) of the 1934 Act, 15 U.S.C. § 78y(a)(1) (1976) (aggrieved party may appeal final Commission order to either D.C. Circuit or circuit in which he resides).

380. See notes 69-78, 92-94 and accompanying text *supra*.

381. See, e.g., W. PAINTER, *THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE* (1979).

382. See, e.g., Lowenfels, *supra* note 322.

under the Advisers and 1940 Acts.³⁸³ On the other hand, the Commission can litigate civil injunctive actions against "any person" who is engaged in or about to engage in violative conduct.³⁸⁴ Consequently, the injunctive remedy has been the SEC's most frequently utilized enforcement weapon.³⁸⁵ Some commentators contend that the injunctive remedy has been overused and perhaps abused.³⁸⁶

The following are arguable abuses by the Commission of the injunctive enforcement remedy:

(1) It names too many persons as defendants in cases where it has strong proof against central defendants but tenuous proof against others more peripheral to the violative acts;

(2) It attempts to regulate professionals such as attorneys and accountants through use of the injunctive remedy just as though they were broker-dealers or investment advisers, even though Congress has never authorized the Commission's direct regulation of such professionals;

(3) It attempts to hold defendants liable for antifraud violations on a mere negligence standard;

(4) It sometimes pursues stale cases where there is no equity for an injunction, where the effect of the lawsuit is really a public "branding" rather than a fair attempt to enjoin reasonably anticipated future statutory violations; and

(5) It forces defendants to accept — primarily in consent settlements — novel forms of ancillary relief which the Congress has never specifically authorized the Commission to seek.³⁸⁷

Such possible abuses must be considered against the backdrop of the SEC's recent dismal record in having the Supreme Court accept its strained statutory interpretations³⁸⁸ and the severe statutory disqualifica-

383. See notes 23-43 and accompanying text *supra*.

384. See, e.g., § 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1976); § 21(d) of the 1934 Act, 15 U.S.C. § 78u(d) (1976).

385. A sampling of available statistics over the last 25 years demonstrates the following: fiscal year 1955 — 23 injunctive actions instituted and 19 injunctions granted against 43 defendants; fiscal year 1966 — 56 injunctive actions instituted and 50 injunctions granted against 181 defendants; fiscal year 1977 — 166 injunctive actions instituted and 336 injunctions granted against 715 defendants. See Levine, *How SEC Will Continue to Use Consent Decrees*, Legal Times of Wash., June 5, 1978, at 16-17.

386. See, e.g., Mathews, *The SEC and Civil Injunctions: It's Time to Give the Commission an Administrative Cease and Desist Remedy*, 6 SEC. REG. L.J. 345 (1979). See also Letter from A.F. Mathews to SEC Advisory Committee on Enforcement Policies and Practices (May 23, 1972), reprinted in MATHEWS, *supra* note 63, at 349-50.

387. Mathews, *supra* note 386, at 347-48.

388. See, e.g., *Touche Ross & Co. v. Redington*, 99 S. Ct. 2479 (1979); *International Bhd. of Teamsters v. Daniels*, 99 S. Ct. 790 (1979); *SEC v. Sloan*, 436 U.S. 103 (1978); *Santa Fe*

tions and other adverse consequences that may be triggered by an injunction, whether entered by consent or after full litigation on the merits.³⁸⁹

The Supreme Court has not yet squarely addressed the SEC's overuse or abuse of the injunctive remedy³⁹⁰ although its attention may be focused on the issue in the pending *Aaron* case.³⁹¹ But district courts and courts of appeals recently have been applying tougher standards in SEC injunctive actions, declining to impose injunctive relief in a significant number of fully litigated cases.³⁹² Judge Friendly, in *SEC v. Commonwealth Chemical Securities, Inc.*,³⁹³ noted that the courts no longer consider the SEC injunctive remedy a "mild prophylactic,"³⁹⁴ the label ascribed to the remedy by both the Second Circuit and the Supreme Court in the 1963 *Capital Gains* case.³⁹⁵ Moreover, Judge Friendly commented that "the current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect than in earlier days."³⁹⁶ Indeed, since the Supreme Court has recently held in *Park-*

Indus., Inc. v. Green, 430 U.S. 462 (1977); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). But see *E.I. duPont de Nemours & Co. v. Collins*, 432 U.S. 46 (1977).

389. For a listing of statutory disqualifications and other direct and indirect consequences of an SEC injunctive decree, see Mathews, *supra* note 290.

390. The Supreme Court has considered only two SEC injunctive cases in the past 20 years. See *SEC v. National Sec., Inc.*, 393 U.S. 453 (1969); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). For a securities law injunctive case in which the SEC was not a party, see *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975).

391. *SEC v. Aaron*, 605 F.2d 612 (2d Cir.), *cert. granted*, 48 U.S.L.W. 3253 (U.S. Oct. 15, 1979) (No. 79-66).

392. See, e.g., *SEC v. Arthur Young & Co.*, 590 F.2d 785 (9th Cir. 1979), *aff'g* *SEC v. Geotek*, 426 F. Supp. 715 (N.D. Cal. 1976); *SEC v. Koracorp*, 575 F.2d 692 (9th Cir.), *cert. denied*, 99 S. Ct. 348 (1978); *SEC v. Parklane Hosiery Co.*, 588 F.2d 1083 (2d Cir. 1977); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977); *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971); *SEC v. Pearson*, 426 F.2d 1339 (10th Cir. 1970); *SEC v. Wills*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,321 (D.D.C. Feb. 11, 1978); *SEC v. Randell*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,362 (E.D. Va. Feb. 24, 1978); *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978); *SEC v. Continental Advisors*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,489 (D.D.C. June 29, 1978); *SEC v. Petrofunds, Inc.*, 414 F. Supp. 1191 (S.D.N.Y. 1976); *SEC v. Harwyn Indus. Corp.*, 326 F. Supp. 943 (S.D.N.Y. 1971); *SEC v. Bangor Punta Corp.*, 331 F. Supp. 1154 (S.D.N.Y. 1971), *aff'd sub nom. Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973).

393. 574 F.2d 90 (2d Cir. 1978).

394. *Id.* at 99.

395. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), *rev'g* 306 F.2d 606 (2d Cir. 1962) (en banc).

396. 574 F.2d at 99.

lane Hosiery Co. v. Shore,³⁹⁷ that facts established in an SEC injunctive action, albeit without a jury trial, may have a collateral estoppel effect in parallel and subsequent private damage actions, the direct and indirect effects of an injunctive action are now much harsher than they were a few years ago when, pursuant to *Rachal v. Hill*,³⁹⁸ there was no danger of collateral estoppel.

What the SEC needs today to alleviate this problem is a new, flexible administrative remedy applicable to any person — or at least to a broader class of persons than available existing administrative remedies reach — that can in fact serve as a “mild prophylactic.” An administrative cease and desist enforcement remedy would provide such an enforcement weapon. The American Law Institute’s proposed Federal Securities Code³⁹⁹ presently contains no such provision. When the Code is introduced in Congress, consideration should be given to adding a provision granting the SEC a new administrative cease and desist enforcement remedy.

The SEC staff has for some time felt that a new administrative remedy would serve the enforcement interests of the Commission while accommodating persons entwined in SEC enforcement problems.⁴⁰⁰ The SEC, however, probably has not proposed legislation to obtain a new administrative remedy because the securities bar and the investment community appear to oppose an expansion of the Commission’s enforcement weapons.⁴⁰¹ Nevertheless, a new remedy along the following lines is worthy of discussion:

The administrative remedy should be much broader than Section 15(c)(4) of the 1934 Act, and should allow the Commission to name as defendants any registrant or issuer that makes 1933 or 1934 Act filings with the SEC, or *any person associated with such a registrant or issuer*, including officers, directors and employees. The remedy would encompass the opportunity of notice, hearing, trial before an administrative law judge, and appeal to the full Commission and ultimately to the courts of appeals. The principal sanction would be an administrative cease and desist order

397. 99 S. Ct. 645 (1979).

398. 435 F.2d 59 (5th Cir. 1970), *cert. denied*, 403 U.S. 904 (1971).

399. *See* note 322 *supra*.

400. *See, e.g.*, Pitt (then SEC General Counsel), Federal Securities Litigation — A Government Perspective, Speech to ALI-ABA Course of Study on Litigation Under the Federal Securities Laws (Feb. 4, 1977).

401. Indeed, opponents of the PROPOSED CODE single out a supposed increased SEC power and authority as one of the principal bases for their opposition. *See, e.g.*, Lowenfels, *supra* note 322, at 617.

restraining a respondent from doing any act that would cause a registrant's or issuer's SEC filings to be false, misleading, incomplete, untimely or otherwise delinquent, or an analogous mandatory administrative order compelling a respondent to take necessary affirmative acts to assure compliance with the filing requirements. The remedy would extend to all filings and reports including proxy soliciting materials. It would also extend to such nonfiling provisions as the books and records and internal controls provisions of Section 102 of the Foreign Corrupt Practices Act of 1977, newly added Section 13(b)(2) of the 1934 Act. Thus, it would be broader than present Section 15(c)(4) proceedings both in range of respondents — individuals would be included — and in conduct and filings covered.⁴⁰²

SEC staff members have suggested that any new remedy should include forms of ancillary relief so that minor cases, such as nonegregious inside information cases, could be settled administratively by way of disgorgement of unfair profits without the accompanying stigma of a harsh court-imposed injunctive decree.⁴⁰³ Without explicit statutory authority, the SEC nevertheless has been very successful in convincing the courts to grant all sorts of innovative ancillary relief in civil injunctive actions.⁴⁰⁴ Obviously, if no ancillary relief were available in the administrative forum, the Commission would probably continue to overuse and abuse the injunctive remedy in order to have a chance to pursue ancillary relief. Consequently, the Commission should be granted a limited authority to seek ancillary relief in connection with an administrative cease and desist remedy: "Perhaps by having Congress specifically consider ancillary relief, and by specifying the range and scope of such available relief in the statutes themselves, the SEC's gradual encroachment upon the internal management of corporations would be somewhat retarded."⁴⁰⁵ The SEC should not, however, be given civil fining powers similar to those Congress has given to the Commodity Futures Trading Commission.⁴⁰⁶

402. Mathews, *supra* note 386, at 353-54.

403. See, e.g., Statement Submitted to Comm'n in Connection with Non-Public Inquiry into Certain Transactions, SEC 1934 Act Release No. 15,665 (Mar. 21, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,015 (§ 21(a) statement).

404. See, e.g., Farrand, *supra* note 3; Mathews, *Recent Trends in SEC Requested Relief in SEC Level [Civil] Injunctive Actions*, 31 BUS. LAW. 1323 (1976); Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. PA. L. REV. 1188 (1975).

405. Mathews, *supra* note 386, at 354.

406. See Commodity Exchange Act §§ 6(c), 14, 7 U.S.C. §§ 13b, 18 (1976). Stanley Sporkin, the SEC's innovative Enforcement Chief, has advocated that "consideration should be given to establishing qualifications for corporate directors with the SEC or another agency having authority to disqualify a person from so acting where he has failed to discharge his responsibilities." See Speech of Stanley Sporkin, 402 SEC. REG. & L. REP. (BNA)

A further advantage of a cease and desist order is that it could fairly be used in stale cases where the statutory violations are not continuing and where there would be no "equity" for an injunction. Publicity would be, and is, a very effective sanction, and if not misused, can be an important weapon in the SEC's arsenal of sanctions: "The administrative adjudication and publication of past violations — with the Commission setting standards in ad hoc administrative enforcement proceedings where a clear exposition of the basis for any theory of violation would be set forth — would be far superior to unexplained lawmaking by consent injunctive decree."⁴⁰⁷ A five-year statute of limitations, however, should be imposed on such administrative adjudications. It would be senseless to adjudicate, solely for publicity, violations more than five years stale.

The opponents of granting the SEC a more flexible administrative enforcement remedy point to the lack of absolute discovery rights in SEC administrative litigation⁴⁰⁸ and the possible institutional bias of SEC administrative law judges.⁴⁰⁹ There is, of course, a way to alleviate such concerns, that is, to grant either to both the SEC and the respondent, or maybe even solely to the respondent, an absolute right of removal of any such administrative enforcement proceeding to the federal courts. Stanley Sporkin, the SEC's ingenious Enforcement Director, has raised this approach for consideration even though he has neither publicly endorsed nor opposed any particular type of proposed new administrative enforcement remedy. Indeed, understandably he has vigorously denied there has been any abuse or overuse of the injunctive action, and has articulated why, in his view, the SEC's enforcement program embracing ancillary relief in the injunctive forum is one of the most effective protectors of the public interest at the federal level.⁴¹⁰

If the federal securities laws are going to be codified, or even if they are not, the SEC should be given a new, relatively moderate administrative

at G-1, (May 11, 1977). Such power would turn the SEC into a federal corporations commission with direct regulatory powers over the fiduciary performance of corporate directors and would most likely be vigorously opposed by the corporate community and the securities bar. See generally Lowenfels, *supra* note 322, at 629 & nn.70-71. A better approach toward achieving directors' sensitivity to their fiduciary and federal securities laws obligations appears to be the "jawboning" approach of SEC Chairman Harold Williams. See H. Williams, *The Role of Inside Counsel* (Oct. 4, 1979) (speech before the 17th Annual Corporate Counsel Institute, Chicago, Illinois), reprinted in [Current] FED. SEC. L. REP. (CCH) ¶ 82,318.

407. Mathews, *supra* note 386, at 354-55, (citing Cohen & Rabin, *supra* note 4).

408. See notes 155-74 and accompanying text *supra*.

409. See Mathews, *supra* note 386, at 356 n.49.

410. See, e.g., Sporkin, *supra* note 286. See also Levine & Herlihy, *SEC Enforcement Actions*, 10 REV. SEC. REG. 951 (1977).

enforcement tool that would eliminate what is perceived by some as an overuse and abuse of the present, very harsh civil injunctive remedy.⁴¹¹

XIII. RAMIFICATIONS FOR LAWYERS OF RECENT AND PENDING RULE 2(E) DISCIPLINARY PROCEEDINGS

In recent years, pursuant to the so-called "market access theory,"⁴¹² one aspect of the SEC's enforcement program has embraced the development of criminal,⁴¹³ civil,⁴¹⁴ and administrative⁴¹⁵ enforcement cases against lawyers.⁴¹⁶ *National Student Marketing*, in the civil injunctive forum, remained the signal case involving the professional conduct of corporate and securities lawyers throughout most of the 1970's.⁴¹⁷ However, in the *National Student Marketing* litigation to date, clear standards for measuring

411. See H. Kripke, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 47-51 (1979). See also Klein, *A Response on SEC Consents — Process Is Corrupting All*, Legal Times of Wash., June 26, 1978, at 20.

412. See Sporkin, *supra* note 286.

413. See, e.g., *United States v. Frank*, 520 F.2d 1287 (2d Cir. 1975), *cert. denied*, 423 U.S. 1087 (1976); *United States v. Persky*, 520 F.2d 283 (2d Cir. 1975); *United States v. Weiner*, 479 F.2d 923 (2d Cir. 1973); *United States v. Kaufman*, 429 F.2d 240 (2d Cir. 1970); *United States v. Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964); *United States v. Koenig*, 388 F. Supp. 670 (S.D.N.Y. 1974).

414. See, e.g., *SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, 99 S. Ct. 1432 (1979); *SEC v. Universal Major Indus. Corp. (Homans)*, 546 F.2d 1044 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977); *SEC v. Spectrum, Ltd. (Schiffman)*, 489 F.2d 535 (2d Cir. 1973); *SEC v. Manor Nursing Centers (Ezrine)*, 458 F.2d 1082 (2d Cir. 1972); *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968); *SEC v. National Student Marketing Corp. (Meyer, Schauer, and Lord, Bissel & Brooks)*, 457 F. Supp. 682 (D.D.C. 1978); *SEC v. Geotek (Lempert)*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,520 (N.D. Cal. July 25, 1978); *SEC v. National Student Marketing Corp. (Epley and White & Case)*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,027 (D.D.C. May 2, 1977); *SEC v. National Student Marketing Corp. (Katz)*, 402 F. Supp. 641 (D.D.C. 1975); *SEC v. Ezrine*, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,594 (S.D.N.Y. Aug. 2, 1972); *SEC v. Century Inv. Transfer Corp. (Caldwell)*, [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,232 (S.D.N.Y. Oct. 5, 1971); *SEC v. Harwyn Indus. Corp. (Gartenberg)*, 326 F. Supp. 943 (S.D.N.Y. 1971).

415. See, e.g., *Richard D. Hodgin*, SEC 1933 Act Release No. 6131 (Sept. 27, 1979); *Jo M. Ferguson*, SEC 1933 Act Release No. 5523 (Aug. 21, 1974); *Emmanual Fields*, SEC 1934 Act Release No. 5404 (June 18, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,407, *aff'd without opinion*, 495 F.2d 1075 (D.C. Cir. 1974); *Murray A. Kivitz*, 44 S.E.C. 600 (1971), *rev'd*, 475 F.2d 956 (D.C. Cir. 1973); *Paul M. Kaufman*, 44 S.E.C. 374 (1970); *Morris Mac Schwebel*, 40 S.E.C. 347 (1960). See also *Schwebel v. SEC*, 153 F. Supp. 701 (D.D.C. 1957), *aff'd*, 251 F.2d 919 (D.C. Cir. 1958); *Mary Jane Melrose*, SEC 1934 Act Release No. 14,720 (May 1, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,578; *MacLaughlin & Stern, Ballen & Miller*, SEC 1934 Act Release No. 11,553 (July 25, 1975); *Irwin L. Germaise*, SEC 1933 Act Release No. 5216 (Dec. 7, 1971).

416. See Mathews, *supra* note 290.

417. See, e.g., *Cheek*, *supra* note 9; *Koch*, *supra* note 9. See also K. BIALKIN & H. PITT, *LIABILITIES OF THE CORPORATE LAWYER: THE IMPACT OF THE NATIONAL STUDENT MARKETING CASE* (Law Journal Seminars Press 1979).

the outer limits of the scope of professional responsibilities of securities lawyers have been set by the settlements negotiated,⁴¹⁸ the district court opinions upon motions,⁴¹⁹ or the trial on the merits.⁴²⁰

Two recent administrative disciplinary proceedings involving lawyers — one of which is currently on appeal to the Commission — demonstrate that without waiting for the courts to lead the way, the Commission intends, through *ad hoc* adjudication of administrative proceedings, to set standards of professional responsibility for corporate and securities lawyers.

A. *The Keating, Muething & Klekamp Case*

In *Keating, Muething & Klekamp*,⁴²¹ pursuant to a rule 2(e)⁴²² settlement disposition, the Commission administratively sanctioned a Cincinnati law firm (KMK) simultaneously with the institution and settlement of a major civil injunctive action against one of KMK's large corporate clients, certain of the client's officers (including the former senior partner of the law firm), and a present partner of KMK who was also a director of one of the client's principal subsidiaries.⁴²³ The law firm's client, American Financial Corporation (AFC), and its subsidiary, American Financial Leasing and Services Company (AFLS), had made untrue statements of, and omitted to state, material facts in SEC filings related to significant transactions. The Commission found:

Because of KMK's involvement with AFC and its subsidiaries, including the participation of various partners in certain of the subject transactions, service by partners of KMK on the Board of Directors of two significant subsidiaries which participated in many of the transactions, and the firm's preparation or review of the subject filings with the Commission, KMK knew or should have known of the material misstatements and omissions in

418. SEC v. National Student Marketing Corp. (Epley and White & Case), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,027 (D.D.C. May 2, 1977).

419. SEC v. National Student Marketing Corp. (Katz), 402 F. Supp. 641 (D.D.C. 1975); SEC v. National Student Marketing Corp., 360 F. Supp. 284 (D.D.C. 1973).

420. SEC v. National Student Marketing Corp. (Meyer, Schauer, and Lord, Bissel & Brook), 457 F. Supp. 682 (D.D.C. 1978), *appeal docketed*, No. 78-1051 (D.C. Cir. Jan. 18, 1978).

421. SEC 1934 Act Release No. 15,982 (July 2, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124.

422. 17 C.F.R. § 201.2(e) (1979).

423. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,982. Keating, the founding partner of KMK, left the firm in 1972 to become AFC's executive vice-president but "continued to have a significant influence over the practice of the firm as it related to AFC and its subsidiaries until 1976." *Id.* at 81,982 n.5.

AFC's and AFLS' filings with the Commission.⁴²⁴

In the first series of inadequately disclosed transactions, labelled the "Klekamp Transactions," AFC's principal officers, during 1972, purportedly purchased \$1.7 million worth of AFC common stock in the open market for Klekamp, a partner of KMK and a director of AFLS, with funds advanced by AFLS.⁴²⁵ Klekamp, who claimed he had arranged initially only for advances and stock purchases totalling \$600,000, was engaged primarily in representing AFLS and other AFC subsidiaries in leasing, financing, and real estate matters. When Klekamp discovered the extent of the transactions and advances, he did not immediately question them. By 1974, Klekamp had encountered severe personal financial difficulties. Consequently, AFC's principal officer, Lindner, supposedly relieved Klekamp of his debt to AFLS, then amounting to over \$1.3 million, in return for Klekamp's surrender of the AFC shares whose market value had fallen to approximately \$422,000. The disclosure of the Klekamp transactions in the annual reports of AFLS and AFC and in the proxy statements of AFLS was wholly inadequate and patently violative of the applicable disclosure provisions of the 1934 Act. In addition, the Klekamp transactions and related circumstances were not disclosed in a 1933 Act registration statement filed by AFLS.⁴²⁶

While KMK attorneys prepared the inadequate filings, Klekamp, who was aware of all the facts, never disclosed the pertinent facts to his law partners and associates. Another KMK partner learned the principal facts from Klekamp in 1975, but he too failed to advise the attorneys preparing the SEC filings of the information he had obtained.⁴²⁷

The second series of inadequately disclosed transactions related to non-disclosures in SEC filings of AFC's and AFLS' activities designed to assist Lindner in having an investment company [UDFIC], owned by him and his brother, sell a bank it owned to an unrelated third party [ANB]. The sale could not be consummated until a large number of "out of area" loans on ANB's books — including loans made to various partners and associates of KMK and to an investment partnership consisting of KMK partners and associates — were eliminated from ANB's loan portfolio. Keating and the UDFIC controller caused AFLS and another AFC subsidiary, Provident Bank, to purchase approximately \$3 million of ANB's "out of area" loans in order to facilitate Lindner's desire to have UDFIC

424. *Id.* at 81,982.

425. *Id.* at 81,982-83.

426. *Id.* at 81,983-84.

427. *Id.* at 81,984.

sell ANB to the third party.⁴²⁸

The Commission criticized AFC's and AFLS' failure to disclose in their respective annual and periodic SEC filings, as related party transactions, the fact that two AFC subsidiaries had purchased the loans from a bank owned and controlled by the president and chairman of the board of AFC to enable him to sell his bank. After describing the involvement of KMK attorneys in various aspects of the transaction,⁴²⁹ the Commission criticized the attorneys as follows:

Despite the involvement by various members of KMK in the bank sale transaction and loan takeovers . . . , KMK failed to accumulate the information concerning these transactions which was known by the members of the firm, and convey it to the member of the firm who was preparing AFC's and AFLS' filings with the Commission. Those members of the firm preparing the filings with the Commission relied on representations by AFC's and AFLS' management concerning related party transactions, and did little, if any, independent verification of the facts on their own. The ANB transaction was not disclosed as a related party transaction in AFC's or AFLS' filings with the Commission.⁴³⁰

The third series of inadequately disclosed transactions involved loans at preferential terms by Provident Bank to various friends and associates of Lindner and Keating, including officers and directors of AFC and its subsidiaries, relatives of such officers and directors, and certain KMK attorneys. AFC's SEC filings improperly represented that Provident's loans to the officers and directors of AFC were made "in the ordinary course of business, and on substantially the same terms as similar loans to unrelated third parties."⁴³¹ The filings failed to disclose any of the preferential loans to officers and directors of AFC's subsidiaries, and other friends, associates and relatives of Lindner and Keating. The Commission criticized this aspect of the law firm's conduct as follows:

428. *Id.*

429. *Id.* at 81,985. The Commission described the attorneys' involvement as follows: Several partners and associates of KMK were aware of the loan takeovers Various attorneys at KMK participated in the preparation and review of the legal documents relating to the sale of ANB, including the sale agreement. In addition . . . KMK served as counsel for UDFIC and ANB in the transaction which resulted in the sale of ANB. Further, one of the partners of KMK served on the Board of Directors of Provident and another partner of KMK served on the Board of Directors of AFLS. Several partners and associates of KMK and the KMK investment partnership had loans at ANB which were purchased by Provident and AFLS pursuant to the loan takeovers.

Id. (footnote omitted).

430. *Id.*

431. *Id.* at 81,986.

Various partners of KMK had knowledge of some of the loans to the Lindner associates and friends, including their own loans, and knew of the terms of such loans which, in certain respects, were preferential. Such information was not conveyed to members of the firm who prepared AFC's filings with the Commission. The persons at the firm preparing the filings relied on representations by AFC's and Provident's management that such loans were made in the ordinary course of business and on comparable terms as with unrelated parties, and did not take sufficient independent steps to determine whether they could rely on such representations.⁴³²

The fourth series of inadequately disclosed transactions involved the "Sci-Tek Leases." AFLS had entered into various sale and leaseback arrangements with an unrelated computer-data processing company, Sci-Tek, Inc., and also made loans to Sci-Tek. Thereafter, AFLS sold various participations in the Sci-Tek leases to Provident and three other UDFIC-Lindner owned banks. When Sci-Tek subsequently encountered financial difficulties, AFLS renegotiated the leases, received a renegotiation fee of \$382,000, and divided the fee among AFLS, Provident, and the other related banks in a manner significantly disproportionate to their respective lease interests. The facts and circumstances concerning the Sci-Tek leases, the lease participations, and the disproportionate allocation of the renegotiation fee, which resulted in the UDFIC-Lindner owned banks receiving an excessive portion of the fee, were not disclosed as required in forms S-1 and 10-K and proxy materials of AFC and AFLS. Neither were other loan transactions between AFLS and one of the banks, arranged for the benefit of another Lindner bank, disclosed as required in pertinent SEC filings. Once again, the KMK firm was held responsible for these omissions as a result of *the collective knowledge of its partners*, including one partner who was a director of Provident.⁴³³

The fifth series of inadequately disclosed transactions involved various

432. *Id.*

433. *Id.* at 81,986-87. The law firm's involvement was as follows:

Various partners and associates of KMK were involved in the preparation and review of the lease documents . . . and were involved in the renegotiation fee. Further, certain attorneys at KMK were in possession of information concerning the renegotiation fee and the indemnification agreements entered into by AFLS and AFC. In addition, one partner of KMK served on the Board of Directors of Provident, and another served on AFLS' Board. Thus, several attorneys at KMK, on a collective basis, had knowledge of all the material facts relating to the Sci-Tek transaction. Despite this knowledge, this related party transaction was omitted from AFC's and AFLS' filings with the Commission.

Id. at 81,987.

loan and other transactions by Provident Bank designed to assist Lindner's investment partnership, UDFIC, in selling a bank it owned to a third party. The KMK firm was again held liable for nondisclosure of these significant related party transactions in AFC's SEC filings on the basis of *the collective knowledge of its partners*, including the partner who was a director of Provident.⁴³⁴

The last inadequately disclosed transaction was a \$600,000 business fee paid to Keating by AFC for his role in the sale by AFC of the Cincinnati Enquirer to a third party in 1975. The fee was paid through KMK to Keating and was initially improperly booked and treated by AFC as a legal expense. The fee was properly disclosed a year later in AFC's proxy materials.⁴³⁵

Even though the law firm agreed to a consent settlement of the case and the issues were not resolved in the traditional adversary trial context, the Commission's decision in *Keating, Muething & Klekamp* generated three opinions: a majority opinion, a concurring opinion by Chairman Williams, and a dissenting opinion by Commissioner Karmel. The majority opinion addresses some of the standards of professional conduct the Commission deems applicable to securities lawyers preparing SEC filings for public companies. The dissent does not deal with the professional standards espoused by the majority but instead argues that the Commission has no legal authority to adjudicate administrative disciplinary proceedings against lawyers. The concurring opinion rebuts the dissent on the jurisdictional issue.

It would be difficult to take issue academically with the professional standards espoused by the majority. There is no question that the facts in the case evidenced egregious conduct, and the substantive legal principles espoused in the context of such extreme facts are sound.

KMK derived from fifty to eighty percent of its billings from representation of AFC and its subsidiaries. Almost every member of the firm participated in representing the AFC complex. Many firm members were familiar with, and participated in, various aspects of the business of AFC and its subsidiaries. Additionally, two partners each sat on the boards of directors of two major AFC subsidiaries.⁴³⁶

The majority opinion indicates that the knowledge of a partner will be imputed to all other partners and to the law firm itself. More importantly, such imputable knowledge includes not only information acquired in the

434. *Id.* at 81,987-88.

435. *Id.* at 81,988.

436. *Id.*

partner's capacity as a lawyer in pursuit of the legal business of the law firm but also information acquired in the partner's capacity as a director in pursuit of the corporate business of the client.⁴³⁷ The majority does not, however, take sides in the current debate over whether lawyers *should* serve on the boards of directors of corporate clients.⁴³⁸ Nor does the majority suggest that the lawyer-director is the "deputy" of the law firm, thereby triggering law firm liability with respect to the business decisions made in the law partner's capacity as corporate director.⁴³⁹ But the majority does establish a professional duty of a law firm preparing SEC filings for a corporate issuer to gather and disclose all material facts known to each member of the firm regardless of the source or circumstances of such knowledge.⁴⁴⁰

Nevertheless, the professional standards espoused, under the *circumstances of the case*, appear quite sound. But it is Commissioner Karmel's dissent that has made *Keating, Muething & Klekamp* a *cause celebre*. Prior to becoming a member of the SEC, Commissioner Karmel had publicly criticized the Commission's adjudication of administrative disciplinary proceedings against lawyers pursuant to rule 2(e).⁴⁴¹ In *Keating, Muething & Klekamp*, Commissioner Karmel, the most significant philosophical dissenter in the history of the SEC, repudiates the assertion that the Commis-

437. *Id.* at 81,988-89.

438. See, e.g., Hawes, *Should Counsel to a Corporation be Barred from Serving as a Director? — A Personal View*, 1 CORP. L. REV. 14 (1978); Mundheim, *Should Code of Professional Responsibility Forbid Lawyers to Serve on Boards of Corporations for Which They Act as Counsel?*, 33 BUS. LAW. 1507 (1978); *Lawyers as Directors*, 30 BUS. LAW. 41 (1975); Note, *Should Lawyers Serve as Directors of Corporations for Which They Act as Counsel?*, 1978 UTAH L. REV. 711.

439. For discussions of the deputization theory, see *Blau v. Lehman*, 368 U.S. 403, 408-10 (1962); *Feder v. Martin Marietta*, 406 F.2d 260, 263 (2d Cir. 1969).

440. The Commission expressed this duty as follows:

A law firm has a duty to make sure that disclosure documents filed with the Commission include all material facts about a client of which it has knowledge as a result of its legal representation of that client. The Commission does not believe it should dictate to law firms how they should structure their internal procedures to assure that the knowledge possessed by their members and associates is made available to those lawyers in the firm responsible for drafting disclosure documents. But it is clear that substantial additional procedures were required here, for the Commission concludes that KMK failed to carry out its professional responsibilities with regard to the above described filings of AFC and its subsidiaries, when, despite its extensive representation of AFC and the knowledge of the members of KMK relating to material transactions, it did not have a system which assured that the knowledge of the members of the firm was communicated to the persons responsible for preparing disclosure of material information — which was within the firm's knowledge — was made.

[1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,989 (footnote omitted).

441. See, e.g., Daley & Karmel, *supra* note 48; Karmel, *supra* note 9.

sion has any statutory jurisdiction to pursue rule 2(e) proceedings against lawyers in an enforcement context.⁴⁴²

Commissioner Karmel carefully analyzes the respective roles of lawyers and accountants vis-a-vis the Commission, the express statutory provisions in the federal securities laws relating to accountants, and the lack of comparable express statutory provisions relating to lawyers. She acknowledges the direct holding of the Court of Appeals for the Second Circuit in *Touche Ross & Co. v. SEC*⁴⁴³ that rule 2(e) is valid with regard to disciplining accountants and rationalizes the correctness of the holding on particular statutory language.⁴⁴⁴

However, she rejects the dicta in *Touche Ross* that would validate rule 2(e) with respect to lawyers.⁴⁴⁵ Commissioner Karmel sets forth very co-

442. Commissioner Karmel stated:

The Commission's authority to promulgate Rule 2(e) is tenuous at best. Since the Commission's program is in aid of its prosecutorial, rather than its rule making or adjudicatory functions, I view it as an invalid exercise of power, particularly where, as here, it is directed at a law firm partnership for conduct which was the basis of an injunction brought by the Commission against an individual partner of the firm and others

As a general policy matter, I believe that it is repugnant to our adversary system of legal representation to permit a prosecutorial agency to discipline attorneys who act as counsel to regulated persons. The frequently made distinction between the lawyer as an adversary versus the lawyer as an advisor cannot and should not be made by an agency with significant prosecutorial responsibilities.

[1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,992 (Commissioner Karmel, dissenting).

443. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,854 (2d Cir. May 10, 1979).

444. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,993. See also R. Karmel, *The Need for Nexus in the Disciplining of Accountants*, Remarks to District of Columbia Chapter, American Society of Women Accountants, in Washington, D.C. (Nov. 7, 1979).

445. Commissioner Karmel explained:

In my opinion, Rule 2(e) is an invalid exercise of the Commission's authority. I recognize that I am not writing on a clean slate, but until the question of the Commission's authority to discipline attorneys is validated by the United States Supreme Court or the Congress, I believe the validity of Rule 2(e) will not be free from doubt. I also recognize that the Commission has brought numerous 2(e) proceedings against attorneys, and that unless the courts or Congress abrogate the rule, the Commission, unfortunately, is unlikely to rescind it. Accordingly, I advocate that the Commission at least confine proceedings against attorneys under Rule 2(e) to cases in which an attorney has improperly conducted himself while personally representing clients before the Commission. Further, the misconduct should thwart the Commission's ability to function or should obstruct administrative justice. In no case, I believe, should the Commission invoke an equivocal administrative remedy like Rule 2(e) to discipline attorneys for conduct which does not directly threaten its administrative processes. To do so, is tantamount to setting professional standards for the practice of law.

[1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,995.

gent arguments why: (i) "it is repugnant to our adversary system of legal representation to permit a prosecutorial agency to discipline attorneys who act as counsel to regulated persons";⁴⁴⁶ (ii) the Commission has neither the mandate nor expertise to set professional or ethical standards for lawyers;⁴⁴⁷ (iii) the Commission cannot legally set qualifications for attorneys practicing before it;⁴⁴⁸ (iv) a lawyer "should not be subject to the severe penalty of disbarment or suspension except upon clear and convincing evidence of intentional wrongdoing";⁴⁴⁹ and (v) rule 2(e) proceedings against lawyers, if they are to be pursued at all, should be narrowly confined "to cases in which an attorney has improperly conducted himself while personally representing clients before the Commission," — that is, "the misconduct should thwart the Commission's ability to function or should obstruct administrative justice."⁴⁵⁰

The last point set forth above is perhaps the most valid: "In no case . . . should the Commission invoke . . . Rule 2(e) to discipline attorneys for conduct which does not directly threaten its administrative processes. To do so, is tantamount to setting professional standards for the practice of law."⁴⁵¹

In his special concurring opinion, SEC Chairman Williams attempts to defuse Commissioner Karmel's dissent by relying heavily on the *Touche Ross* dicta and, in a relatively low-key manner, by citing rather boilerplate rationales for the Commission's assertion of inherent or implied power to administratively discipline attorneys.⁴⁵² The underpinning of Chairman Williams' concurring opinion seems to be that, since the Commission has pursued rule 2(e) proceedings against attorneys for over forty years without a court proscribing the remedy, the remedy must be statutorily valid. But in *Sloan v. NYSE*,⁴⁵³ the Supreme Court, in rejecting the Commission's interpretation of its statutory ten-day trading suspension powers that had gone unchallenged since 1944, soundly rejected any such rationale:

Nor does the existence of a prior administrative practice, even a well-explained one, relieve us of our responsibility to determine whether that practice is consistent with the agency's statutory authority [T]he construction placed on the statute by the Commission, though of long standing, is . . . inconsistent with

446. *Id.* at 81,992.

447. *Id.*

448. *Id.* See also 5 U.S.C. § 500(b) (1976).

449. *Id.* at 81,995 n.21.

450. *Id.* at 81,995.

451. *Id.*

452. *Id.* at 81,989-92 (Chairman Williams, concurring).

453. 436 U.S. 103 (1978).

the statutory mandate And our clear duty in such a situation is to reject the administrative interpretation of the statute.⁴⁵⁴

Until the Supreme Court squarely addresses rule 2(e), its jurisdictional underpinning will remain uncertain. Perhaps the pending *Carter and Johnson*⁴⁵⁵ case will eventually reach the Supreme Court and provide the vehicle for resolving these important administrative law issues. Commissioner Karmel, whether ultimately right or wrong, has boldly brought these issues into the public arena for discussion and debate.

B. *The Carter-Johnson Case*

In 1978, the Commission filed a civil injunctive complaint against Sheldon L. Hart, the former Chairman of the Board, President, and Treasurer of National Telephone Company, Inc. (National); three other National officers; and Price, Waterhouse & Co., National's auditors.⁴⁵⁶ The injunctive complaint alleged violations of the antifraud and reporting provisions based upon nondisclosure in National's SEC filings, shareholder letters, and press releases of serious financial problems of National prior to its bankruptcy. All of the defendants except Hart consented to imposition of an injunctive order by settlement. Hart continued to litigate the case.⁴⁵⁷

Simultaneous with filing the injunctive action, the Commission published a section 21(a) public report of investigation, *National Telephone Co., Inc.*⁴⁵⁸ The section 21(a) report criticized the role of National's outside directors in failing to keep National's shareholders adequately informed on a timely basis of National's deteriorating financial condition and set forth the views of the Commission respecting the duties of outside directors.

In June, 1978, the Commission instituted a private rule 2(e) disciplinary proceeding against William R. Carter and Charles J. Johnson, Jr., partners in the prominent New York City law firm, Brown, Wood, Ivey, Mitchell & Petty, that had been National's outside counsel with respect to the SEC filings that formed the basis of the injunctive complaint and the section 21(a) report. Carter and Johnson were charged with: violating, and aiding

454. *Id.* at 118-19.

455. See William R. Carter, SEC Ad. Pro. File No. 3-5464 (March 7, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175 (initial decision of SEC ALJ), *review granted*, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

456. See *Litigation Involving Price Waterhouse & Co.*, SEC Accounting Release No. 238 (Jan. 16, 1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,260.

457. *Id.* See also SEC v. Hart, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,454 (D.D.C. May 26, 1978) (denial of Hart's motion to dismiss, motion for a more definite statement, and motion to transfer).

458. SEC 1934 Act Release No. 14,380 (Jan. 16, 1978).

and abetting violations of, the antifraud and reporting provisions of the 1934 Act in connection with National's allegedly false SEC filings, shareholders letters, and press releases; lacking "the requisite qualifications to appear and practice before the Commission in the representation of others"; "lacking in character and integrity"; and having "engaged in unethical and improper professional conduct."⁴⁵⁹

After full trial before an SEC administrative law judge, an initial decision was publicly rendered, finding both Carter and Johnson responsible for statutory violations and for knowingly engaging in unethical and improper professional conduct.⁴⁶⁰

National was in the business of designing, leasing, installing, and maintaining telephone systems. It had substantial cash needs to finance equipment and installation costs, which were recoverable in lease payments over the duration of long-term leases. Pursuant to an April 30, 1974 credit agreement with major banks, by September, 1974, National owed its banks over \$15 million. As National's financial condition deteriorated, it was required to negotiate an amended credit agreement with the banks which closed on December 20, 1974 and contained substantial restrictions on National's operations. One of the significant provisions related to a mandatory "lease maintenance plan" (LMP) which was intended to be triggered by any default under the amended credit agreement and which, in effect, would constitute a "wind-down" plan terminating all National's sales activities, converting the company into solely a service organization.⁴⁶¹

On or about December 20 Hart had informed Carter that he did not want the LMP to be publicized or filed with the Commission because he was concerned about the effect the LMP would have on National's sales personnel if its nature became known. Carter, after reading the LMP, advised Hart that the LMP would have to be filed with the Commission if it were an exhibit to the amendment to the credit agreement as had been contemplated. However, Carter told Hart that the LMP need not be filed with the Commission and publicized if it were not an exhibit but rather was merely referred to in the amendment. Thereupon, this change was made in the amendment and the LMP was deleted as an exhibit. Before the close of the December 20 meeting, Carter also reviewed and rewrote a press release which National had

459. William R. Carter, SEC Ad. Pro. File No. 3-5464 (March 7, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175, at 82,165.

460. *Id.* at 82,168-69.

461. *Id.* at 82,169-72.

provided to him to be issued by National to announce the closing of the amended credit agreement.⁴⁶²

The alleged misconduct of Carter and Johnson, as found by SEC administrative law judge Tracy, can be grouped into four general categories:

1. Failure by Carter in the December 20, 1974 press release, which he prepared for National, to cause adequate disclosure of:

(a) the substantial limitations placed on National's operations by the amended agreement;

(b) the nature of the LMP, its material effect on National's operations, and the likelihood that National would be required to implement the LMP within several months; and

(c) the fact that National's earlier predictions of growth were unlikely to be met, due to National's critical cash position and the limitations placed on its growth by the amended agreement.⁴⁶³

2. Failure by both Carter and Johnson to take steps to correct misleading statements in a December 23, 1974 National letter to shareholders, which contained rather bullish statements of National's financial condition and business prospects. The letter, however, "did not refer to the LMP, its nature, its material effect on National's operations, or the likelihood that National would be required to implement the LMP within several months."⁴⁶⁴

3. Failure by Carter adequately to disclose, in a January 8, 1975 form 8-K he prepared for National covering the month of December, 1974, "material facts concerning the LMP and the material effect which the LMP's probable implementation would have on National's operations."⁴⁶⁵

462. *Id.* at 82,172.

463. *Id.* at 82,173.

464. *Id.* at 82,173. Carter and Johnson had advised National not to issue any public statements respecting the amended credit agreement without first clearing them with Brown, Wood. National mailed the December 23, 1974 shareholders letter without so clearing it, but Carter and Johnson learned of the letter and its contents on or about December 27, 1974. *Id.*

465. *Id.* at 82,174. The ALJ explained:

Respondents argue that the order does not allege that the omission of the lease maintenance plan as an exhibit rendered the December 8-K false and misleading. This is true. What the order does allege is that omitted disclosure of material concerning the LMP, among other things, made the 8-K materially false and misleading. When the LMP was omitted as an exhibit it became necessary to adequately describe the LMP either in the 8-K or in the amended agreement. Although, as respondents say, the lease maintenance plan is referred to in several places in the amendatory agreement, nowhere is there a description as to just what it is, or what effect its implementation would have on the company.

If . . . the publication of the LMP would have destroyed employee morale, it is equally probable that it would have affected investors' decisions. It would seem to

4. Failure by both Carter and Johnson to alert National's board of directors that management was making false and misleading disclosures and concealing material facts in National's SEC filings, press releases, and letters to shareholders concerning the nature of the LMP, the requirement for its implementation, its drastic effect on National's business operations, and National's precarious financial condition.⁴⁶⁶

The administrative law judge specifically found that Carter and Johnson, apart from responsibility for statutory violations, engaged in unethical and improper professional conduct by failing to go directly to National's board of directors when Hart disregarded or evaded their disclosure advice.

It is concluded that respondents failed to carry out their professional responsibilities with respect to appropriate disclosure to all concerned, including stockholders, directors and the investing public, of the material facts described herein, and thus knowingly engaged in unethical and improper professional conduct, as charged in the Order.⁴⁶⁷

Severe sanctions were imposed against the respondents — a one-year suspension from practice before the Commission against Carter, and a similar nine-month suspension against Johnson.⁴⁶⁸

Both Carter and Johnson have appealed the case to the Commission, and the matter is presently *sub judice*. The issues in the case are significant

follow that if the LMP contained material information which would be important to employees, that it would likewise be a material fact for investors to know in making a decision. It would appear that stockholders should get the same consideration as employees.

Id. at 82,175.

466. The ALJ's specific conclusion in this regard is instructive:

[Carter and Johnson] were on notice of Hart's callous disregard for complying with securities regulations and his complete indifference to respondents' advice The record is replete with incident after incident where the respondents advised, both orally and in writing, of the need for disclosure of National's financial condition, all of which were ignored. There are numerous incidents previously spelled out in this decision which show that respondents either should have been on notice or actually were on notice of the fact that their advice was being disregarded. These incidents should have, at the least, served as red flags to alert respondents to some course of action which would have prevented the violations found herein. However, the record shows that rather than taking steps to see that the violations did not occur, the respondents participated and assisted in misrepresenting and concealing material information about National from its security holders and the public from May 1974, to May 1975.

Id. at 82,179.

467. *Id.* at 82,183.

468. *Id.* at 82,187.

ones and have captured the interest of the bar.⁴⁶⁹ Prior to analyzing the issues, however, two significant factors concerning this pending appeal should be noted. First, at the request of the SEC General Counsel, Commissioner Karmel disqualified herself from participation in the case.⁴⁷⁰ Second, for one of the few times in its history, the Commission requested the filing by any interested person of *amicus curiae* briefs.⁴⁷¹

Amicus curiae briefs have been filed on behalf of six persons or organizations.⁴⁷² The *amici* briefs, together with the briefs of Carter and Johnson and the SEC General Counsel's Office, collectively raise directly or indirectly the following issues respecting the Commission's litigation of administrative disciplinary proceedings against lawyers pursuant to rule 2(e) as an enforcement tool:

1. Does the Commission have implicit statutory authority to litigate rule 2(e) proceedings against lawyers?⁴⁷³

469. See note 20 *supra*.

470. See Hager, *Karmel Out In Key Carter-Johnson Discipline Case*, Legal Times of Wash., July 30, 1979, at 1. See also Request for Comments on Petition Concerning Disclosure of Relationships Between Attorneys and Registrants, SEC 1934 Act Release No. 16,045 (July 25, 1979) (separate statement of Commissioner Karmel).

471. See Order Permitting Filing of Briefs by *Amici Curiae*, SEC 1934 Act Release No. 15,724 (Apr. 19, 1979).

472. See *amicus curiae* briefs of (i) Los Angeles County Bar Ass'n (July 12, 1979), (ii) Committee on Securities Legislation, Ass'n of the Bar of the City of New York (July 17, 1979), (iii) Section of Corporation, Banking and Business Law, American Bar Ass'n (July 3, 1979), (iv) Michael R. Klein (July 12, 1979), (v) Sullivan & Cromwell (July 18, 1979), and (vi) Arthur F. Mathews (August 7, 1979), William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

Sullivan & Cromwell also filed a Reply Brief *amicus curiae* (November 6, 1979) responding to some of the arguments proffered in the answering brief of the General Counsel (October 15, 1979).

473. The SEC General Counsel's brief argues that it is "beyond cavil" that the Commission has implicit statutory authority to discipline lawyers pursuant to rule 2(e) and cites the following cases in support: *Touche Ross & Co. v. SEC*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,854 (2d Cir. May 10, 1979); *SEC v. Csapo*, 533 F.2d 7 (D.C. Cir. 1976); *Fields v. SEC*, 495 F.2d 1075 (D.C. Cir. 1974); *Kivitz v. SEC*, 475 F.2d 956 (D.C. Cir. 1973); *SEC v. Ezrine*, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,594 (S.D.N.Y. Aug. 2, 1972); *Schwebel v. Orrick*, 153 F. Supp. 701 (D.D.C. 1957), *aff'd on other grounds*, 251 F.2d 919 (D.C. Cir.), *cert. denied*, 356 U.S. 927 (1958); *cf. Goldsmith v. Board of Tax Appeals*, 270 U.S. 117 (1926); *Koden v. Department of Justice*, 564 F.2d 228 (7th Cir. 1977); *Herman v. Dulles*, 205 F.2d 715 (D.C. Cir. 1953). Brief of SEC General Counsel at 4 n.4, William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

Sullivan & Cromwell's *amicus curiae* reply brief, however, persuasively refutes the General Counsel's rather cavalier reliance on such indirect, unpersuasive precedent by proffering four arguments why rule 2(e) as applied to lawyers is invalid: (1) The SEC's general rulemaking authority in section 23(a)(1) — pursuant to which rule 2(e) was promulgated — is limited to promulgating regulations for the discharge of express statutory responsibilities and to making "housekeeping" rules. Rule 2(e) falls in neither category. *Cf. Wallach v.*

2. Can the Commission adjudicate in the first instance in a rule 2(e) proceeding alleged violations of the federal securities laws by a lawyer? If so, may any alleged statutory violations — regardless of the context and circumstances in which they arise or occur — be adjudicated in the administrative disciplinary proceeding? Or must the statutory violations occur in the course of the attorney's "practice before the Commission?"⁴⁷⁴

3. Can the Commission adjudicate violations of, or noncompliance with, professional and ethical standards? If so, may any alleged breaches — regardless of the context and circumstances in which they arise or occur — be adjudicated in the administrative disciplinary proceeding? Or must the professional or ethical breach occur in the course of the attorney's "practice before the Commission?" Moreover, must the Commission apply only the professional and ethical standards espoused by state and federal courts and bar associations, or may the Commission itself set additional ethical and professional standards for securities lawyers?⁴⁷⁵

SEC, 202 F.2d 462 (D.C. Cir. 1953); (2) 5 U.S.C. § 500 (1976) precludes using rule 2(e) against securities lawyers "since there is no 'federal securities bar,' that is a recognized and definable branch of the legal profession practicing 'securities law,' subject to the Commission's special oversight"; (3) The express enforcement provisions in the 1934 Act that reach lawyers — civil injunctive action and criminal prosecution — preclude an implied enforcement action against lawyers. *Cf.* *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); (4) Fundamental policy considerations militate against allowing a regulatory agency to litigate professional disciplinary proceedings against lawyers who represent as clients those persons and entities whom the agencies directly regulate. Regulation of the bar should be left to the courts and the states. *Cf.* *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462 (1977). Reply Brief *Amicus Curiae* of Sullivan & Cromwell at 7, William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

474. The Committee on Securities Regulation of the Association of the Bar of the City of New York argues that rule 2(e) should not be used as an "alternative enforcement tool." It should be used to discipline attorneys only after a violation of law has been established in an independent judicial proceeding in federal or state court, that is, in a civil injunctive action or criminal prosecution, or a breach of ethical or professional responsibility has been established in a disciplinary proceeding before the appropriate state bar authority. Brief *Amicus Curiae* of the Committee on Securities Regulation of the Association of the Bar of the City of New York at 5, William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

Almost all the *amici* briefs argue that whatever rule 2(e) authority exists, it cannot extend to disciplining lawyers for activities that do not constitute "practice before the Commission." 5 U.S.C. § 500(d)(2) (1976) allows a federal agency to discipline "individuals who *appear in a representative capacity* before an agency." Whether this limitation restricts rule 2(e) to the conduct of an attorney appearing as counsel in an SEC adjudicatory proceeding — thereby viewing the rule as akin to a judge's summary contempt power — or whether the rule extends to a lawyer's conduct as adviser or draftsman outside the SEC's presence, is crucial in resolving the *Carter and Johnson* case. See Brief *Amicus Curiae* of Michael R. Klein at 11-12, William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

475. The Section of Corporation, Banking and Business Law of the American Bar Association points out that the "responsibility of lawyers is not a subject about which the Commission has particular expertise. That expertise has long been considered to reside in the

4. What constitutes "practice before the Commission"? Is it limited to the conduct of attorneys when they "appear in a representative capacity before" the Commission? Or does it extend to preparing or counseling with respect to filings made with the Commission? Does it embrace the general "office practice" of an attorney respecting advice or activities concerning any aspect of the federal securities laws even if there is no direct or indirect contact with the Commission? For example, would it include preparation of an opinion letter that a securities transaction is exempt from the federal securities laws or preparation of an offering circular for an exempt offering?⁴⁷⁶

courts and in the bar itself through self-discipline subject to oversight by the courts." Brief *Amicus Curiae* of Section of Corporation, Banking and Business Law, American Bar Ass'n at 25, William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

Similarly, the brief submitted on behalf of Carter and Johnson contends that:

Professional discipline may be imposed only for the violation of validly adopted mandatory standards. ABA Committee on Ethics and Professional Responsibility, Informal Opinion 1420, at 5 (1978) The Commission never has promulgated a code of professional responsibility for securities counsel, nor has it ever adopted the American Bar Association . . . Code of Professional Responsibility.

Brief for William R. Carter and Charles J. Johnson, Jr. at 54-55, William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979). This brief also points out that the SEC administrative law judge in part disciplined Carter and Johnson for unprofessional conduct based on a finding that the respondents engaged in "action inconsistent with Ethical Considerations contained in the ABA Code, an ABA Opinion, a report of an ABA Committee, a resolution of the ABA House of Delegates or articles in an ABA publication." *Id.* at 56-57. The Carter and Johnson brief proceeds to point out a "fatal threshold deficiency in these findings":

[N]one of these statements provides an appropriate basis for the imposition of professional discipline. The Ethical Considerations are by their terms aspirational only; while they can provide assistance in interpreting the Disciplinary Rules, they do not stand on their own as mandatory rules of conduct. Preamble and Preliminary Statement, Code of Professional Responsibility (1977 ed.), p. 1 Nor may an ABA Opinion, an ABA resolution or articles contained in publications such as the ABA's *Business Lawyer* form an independent basis for discipline. ABA Committee on Ethics and Professional Responsibility, Informal Opinion 1420, at 6 (1978).

Id. at 56-57. Thus, the issue is focused: Can the SEC find as a basis for imposing administrative disciplinary sanctions against securities lawyers violations of ethical considerations which the American Bar Association asserts do not constitute a basis for imposition of disciplinary relief against lawyers generally?

476. See, e.g., Brief *Amicus Curiae* of Arthur F. Mathews at 6-7 n.12; Brief *Amicus Curiae* of Sullivan & Cromwell at 13-14; Brief *Amicus Curiae* of Michael R. Klein at 10-13; Brief *Amicus Curiae* of Section of Corporation, Banking and Business Law, American Bar Ass'n at 9-10, 21-24, William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

Commissioner Karmel, dissenting in a recent rule 2(e) proceeding settled by consent and involving a lawyer who had also consented to an injunctive decree, stressed the "practice before the Commission" factor:

I do not believe the Commission has the statutory authority to administratively suspend an attorney's right to practice before this agency solely because he has

5. Are rule 2(e) disciplinary proceedings penal or quasi-criminal, as well as remedial in nature,⁴⁷⁷ thereby requiring that evidence be judged and weighed according to the "clear and convincing" standard of proof?⁴⁷⁸

6. In rule 2(e) proceedings, does responsibility for rule 10b-5 or other fraud violations, whether on a primary or secondary theory of liability, require proof of scienter, and if so, what properly constitutes scienter?⁴⁷⁹

7. In order to justify imposing a sanction more severe than censure, must the Commission in a rule 2(e) proceeding — as is required in a civil injunctive enforcement action in federal court — find a "reasonable likelihood" or "cognizable danger" that, absent such severe sanction, the respondent will commit future statutory violations or engage in professional misconduct?⁴⁸⁰

8. Does a securities lawyer have a duty "to seek higher authority" or "to ensure his advice is followed" by going directly to the board of directors when management ignores the attorney's advice respecting continuing securities law violations by a corporate issuer?⁴⁸¹

been enjoined from violating the federal securities laws. The only conduct by the respondent in his capacity as an attorney in question involved the writing of an opinion letter advising that exemptions from the registration requirement for a securities offering were available. According to the consent settlement, those exemptions were not available. Even if that is so, respondent's conduct in rendering such an opinion did not reach or affect the processes of this agency so as to fall within the limitations I have enunciated for administratively disciplining an attorney under Rule 2(e).

Richard D. Hodgin, SEC 1933 Act. Release No. 6131 (Sept. 27, 1979) (Commissioner Karmel, dissenting). *Accord*, Bernard Jay Coven, SEC 1934 Act Release No. 16,229 (Sept. 26, 1979)(Commissioner Karmel, dissenting).

477. See notes 58-63, 72-73 and accompanying text *supra*. See also Brief *Amicus Curiae* of Arthur F. Mathews at 1-2 n.3.

478. See notes 69-100 and accompanying text *supra*. See also Brief *Amicus Curiae* of Arthur F. Mathews at 2 n.4.

479. See notes 101-12, 125-54 and accompanying text *supra*. See also Brief *Amicus Curiae* of Arthur F. Mathews at 2-5 nn.5-11.

480. See Brief *Amicus Curiae* of Arthur F. Mathews at 7 n.13, William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979). This, of course, is the traditional judicial test for imposing an injunction in the context of an SEC civil injunctive action. See, e.g., *National Student Marketing Corp.* (Lord, Bissel & Brook), 457 F. Supp. 682 (D.D.C. 1978), *appeal docketed*, No. 79-1051 (D.C. Cir. Jan. 18, 1979).

481. The brief *amicus curiae* of the Los Angeles County Bar Association extensively examines whether there are instances when a corporate attorney has a duty "to seek a higher authority" or "to ensure his advice is followed." This brief acknowledges at the outset:

The question of when counsel may have an ethical duty to seek higher corporate authority is an issue not, to our knowledge, heretofore addressed by any code of professional conduct. It certainly has not been resolved by the State Bar of California or by the ABA (although it is currently being debated within the ABA in connection with the pending revision of the Code of Professional Responsibility).

It is obvious that the development of standards to guide the attorney who advises

Whether the Commission resolves any of such issues in the *Carter-Johnson* case, and if so, whether the SEC's resolutions are proper, understandably must await scrutiny by the federal appellate courts. The last issue — whether and under what circumstances a corporate lawyer must go to the board of directors when management disregards the lawyer's legal advice — will, in the long run, significantly effect the conduct of corporate and securities lawyers.

The SEC General Counsel's brief⁴⁸² forcefully argues that the corporation, not management, is the client of the corporate lawyer.⁴⁸³ Under this reasoning, a lawyer has traditional agency obligations to keep his client informed of material facts relating to the subject of the legal representation;⁴⁸⁴ therefore, a corporate lawyer must go to the board of directors when management ignores counsel's legal advice.⁴⁸⁵ Whatever duties the

a corporate client is in an embryonic stage. Our present ethical standards were evolved in the context of litigation obligations, and the lawyer as advocate, and are not at all well suited to the role of the lawyer as corporate adviser.

Brief *Amicus Curiae* of Los Angeles County Bar Ass'n at 4-5 (footnote omitted), William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979). The Los Angeles Bar Association brief then proceeds to suggest, albeit *tentatively*, the following three limited and unusual circumstances under which a corporate attorney whose legal advice is ignored *may* have an obligation to seek a higher authority within the corporation:

1. When the lower-level decision maker has a significant conflict so that his personal interests may differ from those of the corporation, and his judgment may be colored; or
2. When the lower authority proposes a course of action which *clearly* (in the attorney's responsible judgment) violates the securities laws; and,
3. When the proposed activity has extreme and apparent adverse potential consequences for the corporate entity, its shareholders or the public.

Id. at 5-6 (footnote omitted). Finally, the Los Angeles Bar Association brief points out that any disclosure duty imposed on lawyers would pose serious conflicts with existing state law professional standards that require lawyers to hold inviolate the confidences of clients. *Id.* at 9-10. *See, e.g.*, CAL. BUS. & PROF. CODE § 6068(e) (West 1974). *See also* Los Angeles County Bar Ass'n Op. No. 353 (Feb. 12, 1976) (dealing with securities laws violations; copy attached as exhibit to *amicus* brief).

482. *See* Brief of SEC General Counsel at 99-106 nn.133-39, William R. Carter, SEC Ad. Pro. File No. 3-5464 (Mar. 27, 1979).

483. *See* ABA CODE OF PROFESSIONAL RESPONSIBILITY, EC 5-18; Committee on Professional Ethics, Ass'n of the Bar of the City of New York, Opinion No. 385 (Nov. 10, 1936), in OPINIONS OF THE COMMITTEES ON PROFESSIONAL ETHICS OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK AND THE NEW YORK COUNTY LAWYERS' ASSOCIATION 205 (1956); *cf.* *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970); *Transocean Tender Sec. Litigation*, 78 F.R.D. 692 (N.D. Ill. 1978).

484. *See, e.g.*, H. DRINKER, LEGAL ETHICS 102-03 (1953); P. MECHEM, OUTLINES OF THE LAW OF AGENCY § 541 (4th ed. 1952); ABA CODE OF PROFESSIONAL RESPONSIBILITY, EC 7 & 8, DR 6-101(A)(3); 61 ABA JOURNAL 1085-86 (1975).

485. *See* ABA Op. No. 202 (May 25, 1940); ABA Informal Op. No. 1349 (Oct. 6, 1976); Ethics Comm. of the State Bar of Texas, Op. No. 387 (Apr. 1977); Los Angeles County Bar Ass'n, Op. No. 353 (Feb. 12, 1976). *See generally* Cooney, *The Registration Process: The*

Commission espouses in the *Carter-Johnson* case will most likely be acceptable to the bar when — but only when — a court determines that they are proper professional standards. That specific professional duties are articulated, for the first time, in an *ad hoc* administrative disciplinary proceeding imposing sanctions against reputable lawyers is puzzling, and to most segments of the bar, wholly inappropriate.

XIV. CONCLUSION: REENTRY PROCEEDINGS; DUE PROCESS

One gratifying aspect of SEC enforcement practice is that there is no equivalent to a mandatory life sentence in the SEC's arsenal of administrative disciplinary sanctions. Even when the ultimate sanction of revocation or bar is imposed, there is an avenue for eventual relief. The Commission adjudicates "reentry proceedings" in which a disqualified individual or registrant, upon good cause shown, can convince the Commission to lift or modify its previously imposed sanction, thereby allowing the barred person to participate once again in the securities industry.⁴⁸⁶ Similarly, attorneys and other professionals who have been barred pursuant to rule 2(e) proceedings can petition the Commission to lift the sanction so that professional practice before the SEC can be resumed.⁴⁸⁷

Since the Commission from time to time enunciates new legal principles and espouses and refines standards of care applicable to the securities industry, particularly broker-dealers, in the *ad hoc* adjudicatory framework of administrative disciplinary actions, as opposed to rulemaking proceedings, defense of an SEC administrative proceeding should be substantively as well as procedurally challenging and complex.⁴⁸⁸ Administrative and procedural due process issues are often involved.⁴⁸⁹

Role of the Lawyer in Disclosure, 33 BUS. LAW. 1329, 1335 (1978); Cutler, *The Role of the Private Law Firm*, 33 BUS. LAW. 1549 (1978); Meyers, *supra* note 9; Sonde, *supra* note 45, at 9; Van Dusen, *The ABA Code of Professional Responsibility*, 30 BUS. LAW. 15, 16 (1975) (Special Issue: Proceedings, ABA National Institute); *The Code of Professional Responsibility and the Responsibility of Lawyers Engaged in Securities Practice*, 30 BUS. LAW. 1289, 1293-94 (1975).

486. See Applications for Relief from Disqualification, SEC 1934 Act Release No. 11,267 (Feb. 26, 1975), [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,115.

487. See 17 C.F.R. § 201.2(e)(3)(ii) (1979). Sometimes a "re-entry" petition is successful, see, e.g., Plotkin, Yolles, Siegel & Turner, SEC 1933 Act Release No. 6105 (Aug. 15, 1979), and sometimes it is not. See, e.g., Bernard Jay Coven, SEC 1934 Act Release No. 16,229 (Sept. 26, 1979).

488. See *SEC v. Chenery Corp.*, 318 U.S. 80 (1943), *after remand*, 332 U.S. 194 (1947); Cohen & Rabin, *supra* note 4.

489. See, e.g., *SEC v. Chenery Corp.* 318 U.S. 80, 95 (1943) ("an administrative order cannot be upheld unless the grounds upon which the agency acted in exercising its powers were those upon which its actions can be sustained"); cf. *Silver v. New York Stock Exch.*, 373 U.S. 341 (1963)(stock exchange has antitrust immunity only to extent necessary to

And more importantly, as the *Collins* case⁴⁹⁰ demonstrates, the SEC's long-established practices are not necessarily legally correct or acceptable. In this regard, one need only be reminded of Mr. Justice Brennan's recent concurring opinion in *SEC v. Sloan*,⁴⁹¹ in which he pointed out that the majority opinion, although reaching the correct result in condemning the SEC's practice of "rolling over" ten-day trading suspensions, did "not reveal *how flagrantly abusive*"⁴⁹² the SEC's use of its statutory trading suspensions powers has been.

In the final analysis, only an alert defense bar, raising the proper issues, settling the overwhelming amount of cases, but litigating on the merits those in which the staff and the SEC reach too far, will assure the proper development of both adjective and substantive law in SEC administrative disciplinary proceedings.

achieve goals of 1934 Act and must afford affected persons procedural safeguards); *Intercontinental Indus., Inc. v. American Stock Exch.*, 452 F.2d 935 (5th Cir. 1971), *cert. denied*, 409 U.S. 842 (1972) (intimate involvement of stock exchange brings its activities within the purview of 5th amendment due process).

490. *Collins Sec. Corp. v. SEC*, 562 F.2d 820 (D.C. Cir. 1977).

491. 436 U.S. 103, 123 (1978) (Brennan, J., concurring).

492. *Id.* (emphasis supplied).